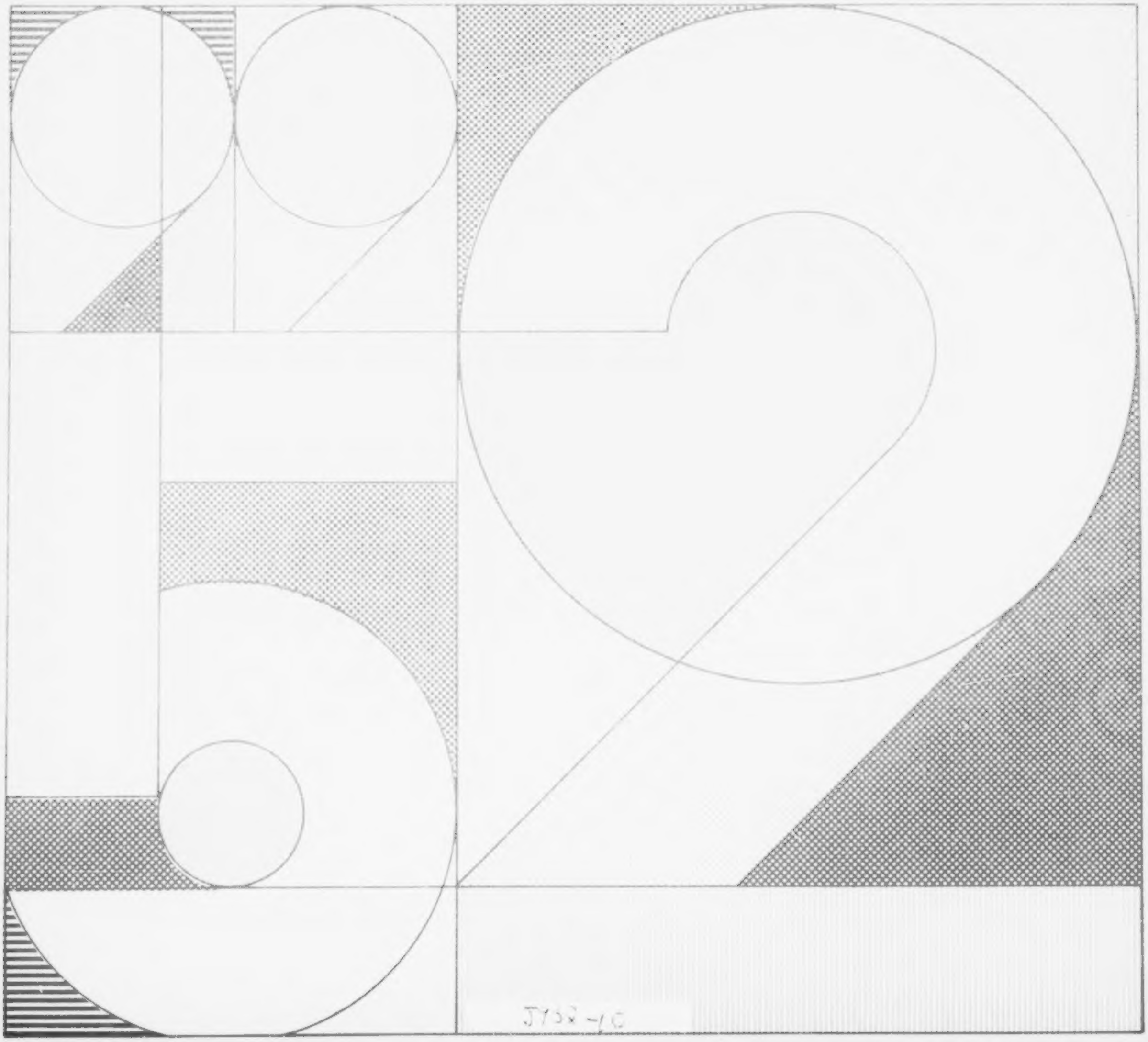
CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

MARCH 1988

Reducing the Deficit: Spending and Revenue Options

A Report to the Senate and House Committees on the Budget — Part II

As Required by Public Law 93-344



J758-1C

1988 ANNUAL REPORT

REDUCING THE DEFICIT;
SPENDING AND REVENUE OPTIONS

The Congress of the United States
Congressional Budget Office

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Washington, DC 20402

NOTES

Unless otherwise indicated, all years referred to in this report are fiscal years.

Dashes in tables in this report indicate amounts less than $2.5 million.

The notation "n.a." in tables means "not available."

Details in the text and tables of this report may not add to totals because of rounding.

The Balanced Budget and Emergency Deficit Control Act of 1985 is also referred to in this volume more briefly as the Balanced Budget Act.

PREFACE

The Congressional Budget Office (CBO) is required by section 202(f) of the Congressional Budget Act of 1974 to submit an annual report on budgetary options to the Senate and House Committees on the Budget. This year, the report is in two parts, with this report constituting Part II. Part I is entitled *The Economic and Budget Outlook: Fiscal Years 1989-1993*.

Chapter I of this report provides general background information on trends in federal spending, revenues, and the deficit. Recent budgetary legislation and Congressional budget process changes are briefly described. The second chapter deals with approaches for cutting the deficit, alternatively, by an across-the-board process or by adopting several broad strategies for retrenchment in spending or expansion of taxes. The next several chapters present specific options in each of the major spending areas and the last chapter reviews specific revenue options. For each option, an attempt is made to present both sides of the case as fairly as possible. CBO does not endorse the options included, nor does exclusion imply any recommendation. This report concludes with an appendix and an index. The appendix lists the options under the budget functions that would be affected. The index is the first attempt to group the options by subject (key words) for those who want to turn only to a few program areas. Readers' comments are welcome on these or other aspects of the report.

All divisions of the Congressional Budget Office contributed to this report, which was prepared under the supervision of Robert W. Hartman. Paul N. Van de Water wrote Chapter I and Everett M. Ehrlich prepared Chapter II. Chapters III through VII were coordinated by John D. Mayer, Wilhelmina A. Leigh, Roger Hitchner, Roger Dower, and Earl A. Armbrust, respectively; Rosemarie Nielsen and Eric Toder coordinated the revenues options presented in Chapter VIII. Budget authority and outlay estimates were coordinated by Charles E. Seagrave, Robert A. Sunshine, Michael A. Miller, and William P. Myers. Revenue and outlay projections were prepared under the supervision of Rosemary D. Marcuss and Paul N. Van de Water, respectively. Edward M. Gramlich, who initiated this year's volume last autumn, provided invaluable comments.

Paul L. Houts supervised the editing and production of the report, assisted by Nancy H. Brooks. Major portions were edited by Amanda Balestrieri, Francis S. Pierce, and Sherry Snyder. Sherry Snyder also compiled the index with help from Mark Desautels. The authors owe special thanks to Mary V. Braxton, Jill Bury, Gwen Coleman, Antoinette V. Foxx, Shirley G. Hornbuckle, Patricia A. Joy, Norma A. Leake, Angela Z. McCullough, and Ronald Moore, who typed the many drafts. Kathryn Quattrone prepared the report for publication.

James L. Blum
Acting Director

March 1988

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CHAPTER I

REDUCING THE DEFICIT: AN OVERVIEW

The Congressional Budget Office (CBO) projects that, under current budgetary policies, the federal government deficit will reach $176 billion in fiscal year 1989. Thereafter, the deficit is projected to decline by only about $10 billion per year. As a result of continued legislative efforts to reduce spending and increase revenues, the outlook for the deficit is much better than it was just a few years ago. Nonetheless, the projected deficits substantially exceed the targets mandated by the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 (Public Law 100-119).

The high budget deficits of the 1980s have contributed to a shortfall in U.S. domestic saving, an inflow of foreign capital, and enormous trade imbalances. In a few years, the United States has changed from the world's largest creditor to its largest debtor. But the growing reluctance of foreign private investors to accumulate dollars is now putting downward pressure on the exchange rate and upward pressure on interest rates. To facilitate a smooth reduction in its trade deficit, the United States is therefore trying to reduce its federal budget deficit, while encouraging countries with trade surpluses to pursue expansionary policies.

This volume is a catalog of broad strategies and specific options for reducing the budget deficit. Because of the size of the problem, the deficit reduction task will not be completed this year. Thus, the strategies and options listed here apply not only to the fiscal year 1989 budget but also indicate some of the choices facing the new President and the Congress as they take office next January.

THE ECONOMIC AND BUDGET OUTLOOK

CBO anticipates that the economy will experience a pronounced slowdown in growth in early 1988, but will regain strength in the second half of 1988 and in 1989. Interest rates are also expected to start rising later this year. On the basis of CBO's short-run economic forecast and a continuation of current budgetary policies, the federal deficit will rise from $150 billion in 1987 to $157 billion in 1988 and $176 billion in 1989. CBO's baseline projections for federal revenues, outlays, and the deficit are shown in Table 1. These projections and the economic assumptions on which they are based are detailed in CBO's recent report, *The Economic and Budget Outlook: Fiscal Years 1989-1993*. The budget projections will be updated as necessary later this month to take account of information gained from the Administration's fiscal year 1989 budget submission.

Beyond 1989, CBO's economic assumptions are not a forecast of future conditions but are projections based on historical growth trends. The projections do not include business cycles but should be considered as an average of a number of possible cyclical paths the economy might take. With continued real economic growth, the baseline deficit is projected to decline slowly to $167 billion in 1990 and $134 billion in 1993. Compared with the size of the nation's economy, the baseline deficit falls from 3.1 percent of the gross national product (GNP) in 1990 to 2.1 percent in 1993.

The baseline assumes that revenues, offsetting receipts, and entitlement spending are projected according to the laws now on the statute books. Defense and nondefense discretionary appropriations are assumed to be held constant in real terms. The baseline projections are, therefore, not forecasts of future budgets, which will doubtless include numerous policy changes. Rather, the baseline serves as a benchmark for analyzing possible alternative policies. The deficit reductions shown in this report are calculated against the CBO baseline, except for the defense options, most of which are compared with the Administration's 1989 budget recommendations.

RECENT BUDGETARY DEVELOPMENTS

The steps that have been taken to hold down the budget deficit have affected both the size and composition of federal revenues and spending. Significant developments have also taken place in both the

TABLE 1. CBO BASELINE BUDGET PROJECTIONS FOR FISCAL YEARS 1989 THROUGH 1993

	1987	1988	Projections				
Category	Actual	Base	1989	1990	1991	1992	1993
In Billions of Dollars							
Revenues							
Individual income	393	390	415	454	494	533	574
Corporate income	84	99	107	119	126	130	134
Social insurance	303	330	352	380	407	433	464
Other	74	78	80	83	84	86	89
Total	854	897	953	1,036	1,112	1,181	1,262
Outlays							
National defense	282	287	295	306	320	333	345
Nondefense discretionary spending	164	175	193	202	207	215	221
Entitlements and other mandatory spending	474	497	533	572	610	649	693
Net interest	139	151	166	184	196	201	206
Offsetting receipts	-54	-55	-58	-61	-63	-66	-69
Total	1,005	1,055	1,129	1,203	1,269	1,332	1,396
Deficit	150	157	176	167	158	151	134
As a Percentage of GNP							
Revenues							
Individual income	8.9	8.3	8.3	8.5	8.7	8.8	8.8
Corporate income	1.9	2.1	2.1	2.2	2.2	2.1	2.1
Social insurance	6.9	7.1	7.1	7.1	7.2	7.1	7.1
Other	1.7	1.7	1.6	1.6	1.5	1.4	1.4
Total	19.4	19.2	19.1	19.4	19.5	19.4	19.4
Outlays							
National defense	6.4	6.1	5.9	5.8	5.6	5.5	5.3
Nondefense discretionary spending	3.7	3.7	3.9	3.8	3.6	3.5	3.4
Entitlements and other mandatory spending	10.8	10.6	10.7	10.7	10.7	10.7	10.7
Net interest	3.1	3.2	3.3	3.4	3.4	3.3	3.2
Offsetting receipts	-1.2	-1.2	-1.2	-1.1	-1.1	-1.1	-1.1
Total	22.8	22.5	22.7	22.6	22.3	21.9	21.5
Deficit	3.4	3.4	3.5	3.1	2.8	2.5	2.1

SOURCE: Congressional Budget Office.
NOTE: Totals include Social Security revenues and outlays, which are off-budget.

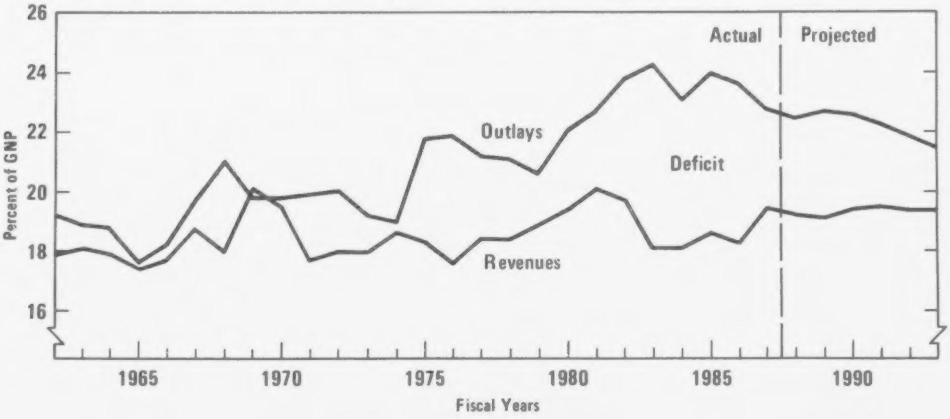
formal government budgeting process and in the way the process has actually worked.

Trends in Taxes and Spending

During the 1960s and 1970s, federal government revenues absorbed a roughly constant share of the gross national product (see Figure 1). Although the revenue-to-GNP ratio varied from year to year, it averaged 18.3 percent for both decades. Revenues grew rapidly in 1979, 1980, and 1981, however, as inflation pushed taxpayers into higher personal income tax brackets. But after reaching 20.1 percent in 1981, the ratio of revenues to GNP fell back to the mid-18 percent range in the wake of the Economic Recovery Tax Act of 1981. Subsequent tax increases cause the revenue share of GNP to stabilize at about 19.4 percent of GNP in CBO's baseline projections.

While revenues now absorb only a slightly larger share of GNP than in the 1960s, outlays are considerably greater. Changes in en-

Figure 1.
Baseline Revenues and Outlays



SOURCE: Congressional Budget Office.

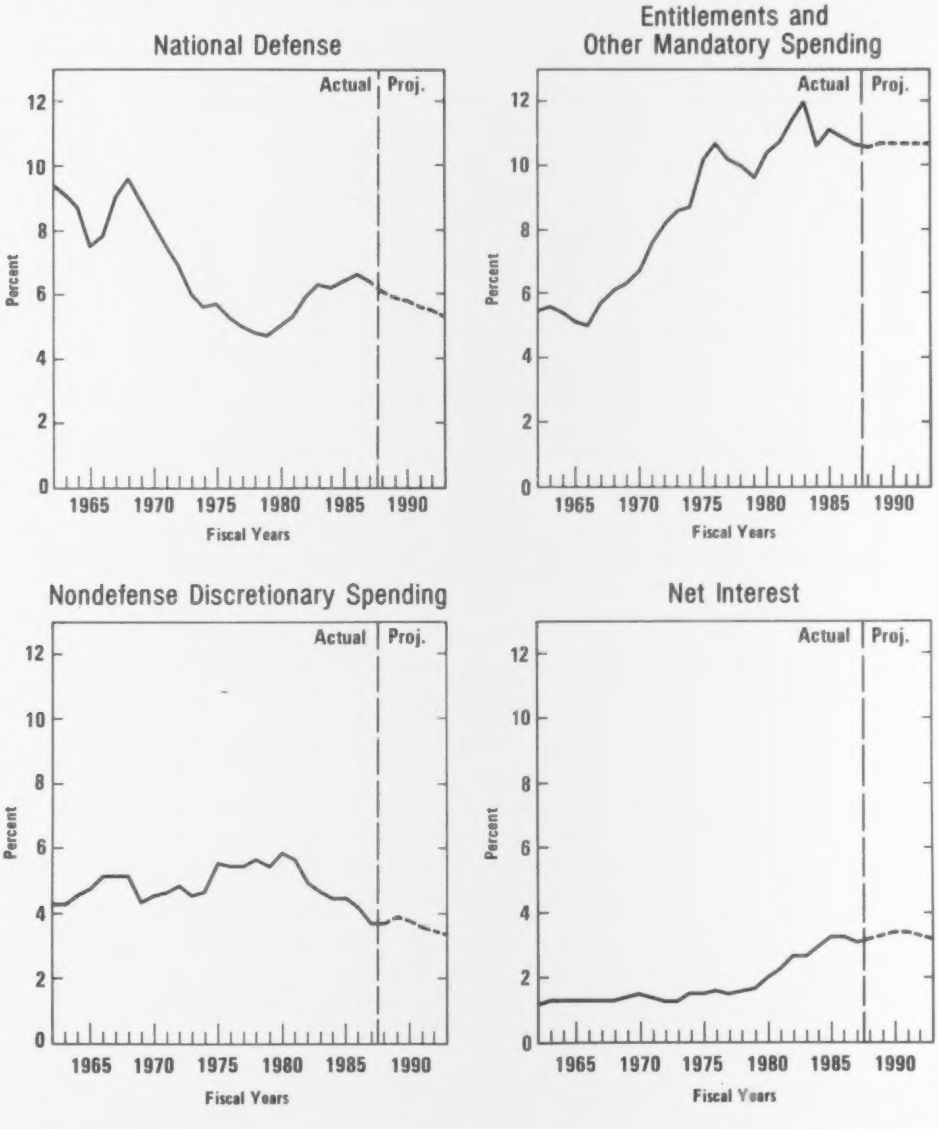
titlements and national defense spending tell the story. In the mid-1960s, entitlements and defense grew simultaneously, as the start of Medicare, Medicaid, and other Great Society programs coincided with the Vietnam War buildup (see Figure 2). Outlays surged from about 19 percent of GNP in the early 1960s to 21 percent in 1968, as shown earlier in Figure 1. Ten years later, in 1978 and 1979, the ratio of total spending to GNP was still 21 percent. Entitlement spending (which includes Social Security, Medicare, federal employee retirement, unemployment compensation, farm price supports, and most means-tested benefits) continued to grow during the 1970s, but the share of defense spending in GNP declined by about the same amount.

From 1980 to 1983, however, defense and entitlements again grew in tandem, and total spending reached a record level of 24.3 percent of GNP in 1983. The defense increases reflected a redirection of national policy. But the entitlement growth was largely automatic, resulting from such factors as large cost-of-living increases, high unemployment in the 1982-1983 recession, and rapidly rising medical care costs.

Under current budgetary policies, federal spending as a share of GNP is projected to fall from 22.8 percent in 1987 to 21.5 percent in 1993. The defense buildup peaked in 1986, when defense outlays reached 6.5 percent of GNP. Assuming no real growth in appropriations, defense spending will continue to decline, falling to 5.3 percent of GNP by 1993--the same level as in 1981. Entitlement spending reached a maximum of 12.0 percent of GNP in 1983 as a result of the recession, fell off sharply thereafter, and is now projected to remain level at about 10.7 percent of GNP. Large deficits and high interest rates propelled net interest outlays from 1.7 percent to 3.3 percent of GNP in the early 1980s, but the ratio of interest spending to the GNP has been relatively level since 1985.

Nondefense discretionary programs have borne the brunt of budgetary restraint in the 1980s, declining from almost 6 percent of GNP at the start of the decade to 3.7 percent at present and a projected 3.4 percent in 1993. These programs cover a wide variety of federal activities, including international affairs, transportation, veterans' medical care, and the legislative, judicial, and tax-collecting functions. Slightly over a fifth of nondefense discretionary outlays provide

Figure 2.
Outlays by Category as Shares of GNP



SOURCE: Congressional Budget Office.

pay and benefits for employees of the civilian agencies of government, and about a third of them represent grants-in-aid to state or local governments.

Changes in the Budget Process

In late 1985, faced with large and growing deficits, the Congress adopted the Balanced Budget and Emergency Deficit Control Act (Public Law 99-177), popularly known as Gramm-Rudman-Hollings. The law established steadily declining deficit targets, culminating in a balanced budget in fiscal year 1991. The law also created an automatic mechanism, termed sequestration, to cancel budgetary resources on an across-the-board basis if the projected deficit in any year exceeded the target.

The new law, however, could not cope with certain judicial and economic developments. On July 7, 1986, the Supreme Court decided that the automatic deficit reduction procedures of the Balanced Budget Act were unconstitutional. The court ruled that the act violated the principle of separation of powers by granting the Comptroller General, an official of the legislative branch, authority to determine the size and composition of the final sequestration order. Also, the economic forecasts underlying the budget projections gradually deteriorated. By August 1987, CBO was projecting a baseline deficit of $183 billion for fiscal year 1988, putting the $108 billion target completely out of reach.

In September 1987, the Congress rewrote the Balanced Budget Act. The Balanced Budget Reaffirmation Act set new deficit targets and delayed the date for achieving a balanced budget to 1993. It also modified the sequestration procedures to make them pass constitutional muster. For fiscal year 1989, across-the-board cancellation of budgetary resources will be triggered automatically if the deficit estimated on October 15, 1988, exceeds $146 billion (the $136 billion target plus a $10 billion margin of error) and if deficit reduction measures achieved since January 1, 1988, total less than $36 billion.

Under the Reaffirmation Act, the Director of the Office of Management and Budget (OMB) determines each year whether or not sequestration is necessary and how large the cuts must be. CBO provides OMB and the Congress with advisory reports, against which the Congress and others may assess the OMB calculations. If either OMB or CBO projects real economic growth to be less than zero for each of two consecutive quarters, or if the Department of Commerce reports actual real growth to have been less than 1 percent for two consecutive quarters, the Congress may suspend many of the provisions of the act. This year, an initial sequestration order would be issued on August 25 and a final order on October 15.

The Budget Summit

For fiscal year 1988, the Balanced Budget Reaffirmation Act required $23 billion in deficit reduction, but for the Congress and the Administration agreeing on how to achieve this target proved more difficult than agreeing on the target itself. The Congressional budget resolution for 1988 was unacceptable to the Administration because it called for $21 billion in revenue increases. No one wanted sequestration, but it seemed increasingly likely as a stalemate loomed.

Soon after the stock market crash of October 19, however, Congressional leaders from both parties and representatives of the Administration began budget negotiations. On November 20, the President and the negotiators announced an agreement to cut the deficit by $30 billion in 1988 and $46 billion in 1989. A month later the Congress passed two laws--an appropriation measure and a reconcilation bill--substantially carrying out the agreement. Table 2 summarizes the deficit reduction already achieved and the additional reductions still required to meet the terms of the summit agreement.

The summit agreement contains a novel feature: separate two-year limits on both defense and nondefense discretionary appropriations. These appropriation caps, found in the Omnibus Budget Reconciliation Act of 1987 (Public Law 100-203), are to serve as the basis for the committee spending allocations in the 1989 Congressional budget resolution. In the Senate, it will not be in order to consider a 1989 budget resolution that exceeds the caps, unless the point of order is overridden by a three-fifths vote.

TABLE 2. THE BUDGET SUMMIT AGREEMENT
(By fiscal year, in billions of dollars)

	1988	1989
Deficit Reduction Already Achieved		
Revenues		
Taxes	9.2	14.2
IRS compliance (gross)	1.8	2.5
User fees	-0.5	-0.6
Total	10.5	16.1
Outlays		
National defense	5.1	7.4
Nondefense discretionary	2.5	1.6
Entitlements and other mandatory spending		
Medicare	2.1	3.8
Farm price supports	1.2	0.9
Postal Service and Civil Service	0.8	0.6
Pension Benefit Guaranty Corporation premiums	0.4	0.4
Veterans housing loan sales and fees	0.8	0.8
Guaranteed Student Loan balances	0.2	--
Other	0.2	-0.4
Subtotal	5.7	6.2
Other user fees (offsetting receipts)	0.8	0.9
Asset sales and prepayments	7.7	--
Net interest	1.3	3.4
Total	23.1	19.5
Deficit Reduction	33.6	35.6
Additional Deficit Reduction to be Achieved		
Revenues--IRS Compliance	--	0.4
Outlays		
National defense	--	1.2
Nondefense discretionary	--	1.8
Asset sales	--	3.5
Net interest	--	0.3
Total	--	6.8
Deficit Reduction	--	7.2
Total Deficit Reduction		
Deficit Reduction	33.6	42.8

SOURCE: Congressional Budget Office.

The CBO baseline projections do not reflect the 1989 savings from the appropriation caps because these savings remain to be enacted. Instead, the baseline assumes 1989 appropriations based on the 1988 amounts adjusted for inflation of roughly 4 percent. The caps, in contrast, allow increases in budget authority of only 2.5 percent for defense and 2.0 percent for nondefense programs. Adhering to these limits would further reduce 1989 outlays by roughly $1.2 billion in defense and $1.8 billion in nondefense programs. The reconciliation bill also calls for selling an additional $3.5 billion of assets in 1989. Finally, $0.4 billion in revenues would result from further boosts in IRS enforcement resources. Together with the resulting savings in debt service costs, these measures would save $7.2 billion, bringing the total 1989 deficit reduction to $42.8 billion. The total two-year deficit reduction would be $76 billion--exactly on target.

THE TASK AHEAD

At the time the budget summit was concluded, the agreement was thought to meet the Balanced Budget Reaffirmation Act's deficit reduction targets in both fiscal years 1988 and 1989. But the anticipated economic slowdown has worsened the deficit outlook. Under CBO's current short-run economic forecast, the 1989 baseline deficit of $176 billion is well above the deficit target of $136 billion.

The amount of deficit reduction required in 1989 is limited by the Reaffirmation Act to $36 billion. Excluding asset sales, which may not be counted for this purpose, implementing the rest of the budget summit for 1989 would produce about $4 billion of the needed savings. But another $32 billion in deficit reduction would still be required. If the Office of Management and Budget comes up with similar estimates this summer, it would trigger across-the-board cuts of roughly 9 percent in defense programs and 13 percent in nondefense programs from their baseline levels.

These cuts could be avoided if OMB's estimate of the deficit were less than $146 billion. Although by using economic assumptions more favorable than CBO's, OMB could reduce the projected deficit to that level, relying on this approach to get through the 1989 budget year would make the 1990 deficit reduction task that much harder. Taking no action this year beyond that required by the budget summit would leave the 1990 deficit around $160 billion, according to CBO's current estimates. With a 1990 deficit target of $100 billion, the excess deficit would be $60 billion, almost double the amount of deficit reduction achieved in the first year of the summit.

However much or little deficit reduction is accomplished this year, more will remain to be done next year by the new President and the Congress. They will be advised by a bipartisan National Economic Commission established by the recent reconciliation bill. The commission is directed to recommend specific methods of reducing the deficit, while promoting economic growth and ensuring an equitable distribution of the burden. This volume provides an extensive, but not exhaustive, introduction to the options from which the commission, the Congress, and the President may choose.

HOW TO USE THIS VOLUME

Chapter II discusses two broad approaches to deficit reduction--formula methods, including sequestration and budget freezes, and programmatic strategies. It identifies six public policy themes that may serve as the basis for building a deficit reduction plan. The following chapters--devoted to national defense, entitlements and other mandatory spending, agricultural price supports, nondefense discretionary programs, federal work force, and revenues--list specific deficit reduction options. Each option includes a short description of its pros and cons, together with the estimated savings or revenue gains for each of the years 1989 through 1993. Some of the savings estimates may change slightly when the CBO baseline is updated later this month. Variations on any option may, of course, be constructed, with corresponding variations in savings.

For two reasons, the separate options cannot be added to a grand total. First, the savings effects of each are calculated separately, as if none of the others were to become law, but in fact there would be interactions among the options if many of them were enacted. In fact, a number of the options are mutually exclusive. Second, any reduction in outlays or increase in revenues will result in a lower public debt and therefore in lower net interest costs than would otherwise be the case. The estimates for the specific options do not include these induced interest savings, but interest savings would have to be taken into account in costing a complete budget plan.

Finally, the Congressional Budget Office does not make substantive policy recommendations. The appearance of an item among the listed options therefore must not be taken as a CBO endorsement. Similarly, the absence of an item should not be construed as CBO opposition to its enactment.

The Table of Contents lists the options covered in each chapter. For a listing of options grouped by budget function, see the Appendix. For a topical listing, see the Index.

CHAPTER II

DEFICIT REDUCTION STRATEGIES

The federal budget is a statement not only of the government's cash flow but of its national priorities. Significant changes in size or composition of the budget, whether carried out by formula approaches or program-by-program review, inescapably represent significant changes in the federal government's policy role.

One general strategy for deficit reduction is to reduce spending through freezes or other across-the-board methods. The sequestration procedure found in the Balanced Budget Reaffirmation Act is the most prominent example of this approach. These techniques seek to cut spending while preserving the policies and priorities currently found in the budget. For a variety of reasons, however, these "formula strategies" often fail to be even-handed or balanced, particularly if they are called on to reduce as large a deficit as is found in the CBO baseline.

The alternative to these formula approaches to deficit reduction is to base spending cuts and revenue increases on explicit public policy rationales. This volume contains 130 deficit reduction options. Each is presented along with the arguments often put forward by its proponents and opponents. But many of the options have common, broader policy implications. The public policy themes that deficit reduction options share are the subject of this chapter.

Like the list of deficit reduction options themselves, a list of the public policy themes they embody can be comprehensive but by no means exhaustive. The shared policy themes identified in this chapter are the following:

- *Reduce Public Consumption.* Reduce the public-sector's role by cutting back on federal activities that typically cannot be provided by the private sector or other levels of government (for example, by reducing expenditures for defense, basic scientific research, energy security, or many redistributive programs).

- *Reassign Responsibilities.* Shift responsibilities for achieving social goals to state and local governments (for example, by making state and local governments assume greater or sole responsibility for such programs as transportation, housing, or water resources programs).

- *Improve Efficiency.* Increase the efficiency of federal programs by improving their management (for example, by producing resources from federal lands only when economically justified or by using private-sector contractors when appropriate), or by improving the incentives found in spending or tax programs (for example, by changing the terms on which unemployment insurance is offered or by broadening the base of the income tax).

- *Make the Prices of Goods Reflect Their True Costs.* Have consumers pay an appropriate share of the costs for the goods and services they consume by charging them full cost for services provided by the federal government (for example, by eliminating subsidies provided through the Post Office, Coast Guard, Airport and Airways Trust Fund, or federal water projects); by recalculating program parameters (for example, by recalculating Medicare's indirect teaching adjustment using more recent cost data); or by using taxes to make the prices of goods reflect more accurately their true social costs (for example, by increasing excise taxes on cigarettes or alcohol).

- *Distribute the Burden to Those Who Can More Easily Pay.* Move more of the burden of balancing the federal budget to those who can more easily pay (for example, by enacting stricter eligibility criteria for federal subsidies, targeting benefits, or enacting progressive increases in the income tax).

- *Increase Taxes to Balance Public Expenditures.* Lower the deficit without reducing the share of national income directed to the public sector by instituting excise taxes or broadening the base of the income tax (as discussed above); by raising existing tax rates (for example, the rates currently found in the individual and corporate income taxes); or by instituting new forms of taxation (such as a consumption tax).

These six themes capture the spirit of most of the programmatic deficit reduction options found in this volume. The remainder of this chapter first discusses the formula approach to deficit reduction and the problems inherent in it. The chapter then discusses each of these public policy themes and cites examples of deficit reduction options associated with each. The chapter ends with a consideration of some of the other constraints on the choice of deficit reduction strategies.

FORMULA APPROACHES TO DEFICIT REDUCTION

Concern over the economic dangers posed by sustained deficits has led many Members of the Congress to advocate arithmetic formulas or other "rules of thumb" to produce across-the-board reductions in federal spending. The approach promises a simple, quick response to the economic danger posed by excessive deficits. Formula approaches can produce large deficit savings without requiring a program-by-program debate. Such approaches also may have the appeal of providing a broad sharing of the burden of deficit reduction by affecting all or most federal programs.

Design Problems

The primary disadvantage of the formula approach is that it can have highly arbitrary effects on programs and policies. While formulas that reduce all programs by a fixed percentage (or hold all programs constant) appear to be even-handed, a fixed reduction in all spending can have greatly differing effects on the benefits realized through individual programs, since benefits that various programs produce may vary widely at the margin. Such arbitrary effects are exacerbated when formulas are applied to large deficits over a long period of time.

A general class of problems regarding formula approaches concerns the relationship between outlays and budget authority. Budget formula proposals are sometimes intended to produce uniform reductions in outlays. But the Congress does not control budget outlays; it provides budget authority and other budgetary resources that ultimately are transformed into outlays. Nor do the individual agencies of government control specifically the timing or amount of outlays; instead, their administrative mechanisms are designed to ensure that agency obligations do not exceed their budget authority.

Further, the rate at which budget authority results in outlays differs substantially among different programs. An appropriation for building a nuclear aircraft carrier may take seven years or more to be transformed into outlays, while most appropriations for agency salaries and operating expenses are spent quickly. Thus, achieving uniform changes in outlays over a given time period would require widely varying changes in budget authority among accounts. For many slow-spending accounts, it would be impossible to cut outlay growth significantly without rescinding appropriations from previous years or even canceling contracts. For these reasons, to achieve outlay reductions, most formula approaches--including the sequestration procedure--treat budget authority and other types of spending authority uniformly. And, while budget authority is the only measure that can be controlled, it is ultimately unclear which measure--outlays or budget authority--better represents the level of federal policy efforts.

Although general formulas can be applied to appropriations for national defense and nondefense discretionary spending programs, it is difficult to apply growth-rate formulas to entitlements and other mandatory programs. Spending for these programs is controlled not by annual appropriations but by rules that determine the eligibility for and the amount of benefits. For those entitlement programs with annual cost-of-living adjustments (COLAs), across-the-board outlay reductions may easily be achieved by modifying the COLAs. But the formula approach can be applied to the remaining entitlement programs only by changing the eligibility rules, benefit levels, or (when relevant) reimbursement rates with the goal of achieving estimated savings targets.

Finally, net interest costs, which depend on the amount of interest-bearing debt held by the public and on interest rates, cannot be incorporated into a formula approach.

Table 3 contains a sampling of formula options that have recently been put forward and shows for each the resulting savings from CBO's baseline projections. Many formula budget plans could be constructed from this table by selecting one option from each category and summing the annual budget savings. For example, eliminating all cost-of-living adjustments in non-means-tested programs for five years would produce savings of $178.5 billion over the next five years. Eliminating pay adjustments for all federal civilian employees would produce five-year savings of $21.1 billion. (All spending reductions cited in this chapter are outlay savings.) Other formula-type deficit reductions can be found elsewhere in this volume.

The Sequestration Procedure

Some of the problems in applying a formula approach to deficit reduction are illustrated in the sequestration procedure found in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 (Public Law 100-119). While that procedure was conceived as a way to create an even-handed distribution of the burden of deficit reduction, it nonetheless reflects a specific set of spending priorities.

First, many programs are fully exempt from sequestration. These programs include Social Security, federal retirement and disability benefits, the Earned Income Tax Credit and other programs aimed at the low-income population, veterans compensation and pensions, and state unemployment benefits. The President may exempt military personnel and may propose other defense exemptions, subject to Congressional approval. Other programs and activities, while not exempt, are subject to special rules that limit the amount of the spending reduction. Notably, Medicare and health programs for veterans and Native Americans may be reduced by no more than 2 percent.

TABLE 3. ILLUSTRATIVE FORMULA-TYPE BUDGET OPTIONS
(By fiscal year, in billions of dollars)

	Deficit Reduction				
	1989	1990	1991	1992	1993
National Defense a/					
One-year program-level freeze and pay freeze	-5.2	-8.9	-10.5	-11.5	-12.2
Increase program levels and pay by 2 percent per year	-2.8	-7.3	-12.6	-18.6	-25.0
No increase in program levels or pay	-5.2	-14.0	-24.3	-35.6	-47.5
Cost-of-Living Adjustments (COLAs) b/					
No COLAs for one year	-8.8	-11.8	-11.9	-11.9	-11.7
COLAs of 2 percent per year	-5.2	-13.3	-21.3	-29.0	-36.8
No COLAs for five years	-8.8	-22.3	-35.9	-49.1	-62.4
Nondefense Discretionary Spending					
One-year program level freeze	-2.6	-4.0	-5.1	-5.3	-5.6
Increase program levels by 2 percent per year	-1.3	-3.3	-5.9	-9.0	-12.0
No increase in program levels	-2.6	-6.7	-11.9	-18.0	-24.1
Medicare					
One-year freeze in reimbursement rates	-1.6	-2.0	-2.1	-2.3	-2.6
Increase reimbursement rates by 2 percent per year	-0.5	-2.5	-4.7	-7.5	-10.4
Civilian Agency Pay Raises a/					
One-year freeze in pay raises	-1.0	-1.6	-1.7	-1.8	-1.9
Increase pay by 2 percent per year	-0.6	-1.4	-2.2	-3.1	-4.0
No pay raises	-1.0	-2.6	-4.2	-5.8	-7.5
Individual Income Taxes					
Delay indexing until 1990	-3.7	-6.1	-6.6	-7.1	-7.6
Repeal indexing	-3.7	-12.0	-23.6	-36.9	-51.6

SOURCE: Congressional Budget Office.

a. These calculations are net of offsets for employer payments to employee retirement funds.

b. These calculations exclude means-tested programs.

The first-year outlay reductions compelled by the deficit targets are then divided evenly between defense and nondefense programs. The required outlay reductions for each of these two groups (after subtracting the savings from the "special rule" programs) are achieved by cutting sequestrable budgetary resources in each category by a uniform percentage.

While the sequestration technique permits budget reduction in many programs through a single action, limiting across-the-board cuts to a subset of federal spending requires even greater percentage reductions in those programs that are left in the base. This approach creates two classes of programs--"advantaged" and "disadvantaged"--although the differing policy effectiveness of the two groups is probably far less obvious. Moreover, when uniform percentage spending reductions must be applied to all programs, projects, and activities financed in a budget account, as is the case for nondefense programs, they are particularly apt to be arbitrary.

The Effects of Budget Freezes

One type of formula budget plan is a freeze. For appropriated budget accounts, one definition of a freeze is to hold budget authority fixed in dollar terms from one year to the next. A budget authority freeze, however, would not permit the increases in federal pay and other benefits already enacted into law. Eliminating discretionary adjustments for inflation (often called a program-level freeze) allows for these mandated increases but for no further increases in either pay or nonpay costs. Cost-of-living increases can be canceled and Medicare reimbursement rates can be frozen, but freezes cannot easily be applied to other categories of spending such as food stamps, where spending depends on eligibility criteria.

Table 4 shows the effects on the deficit of an illustrative, broadly based, one-year freeze in fiscal year 1989. That option would reduce the deficit by $20.1 billion in 1989 and, by producing savings in subsequent years, would lead to budget savings of $176.4 billion over the next five years.

PROGRAMMATIC APPROACHES TO DEFICIT REDUCTION

The alternative to a formula approach is to focus on the policy implications of various deficit reduction options. This section discusses the six public policy themes exemplified by the deficit reduction options found in this volume.

Reduce Public Consumption

One interpretation of large and persistent budget deficits in the 1980s might be that the public is unwilling to pay for all of the current expenditures it receives from the federal government. Some federal

TABLE 4. ILLUSTRATIVE ONE-YEAR BUDGETARY FREEZE (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993
CBO Baseline Deficit	176	167	158	151	134
Policy Changes					
One-year program-level and pay freeze for defense a/	-5.2	-8.9	-10.5	-11.5	-12.2
One-year COLA freeze b/	-8.8	-11.8	-11.9	-11.9	-11.7
One-year program level freeze for nondefense discretionary programs	-2.6	-4.0	-5.1	-5.3	-5.6
One-year freeze in Medicare reimbursement rates	-1.6	-2.0	-2.1	-2.3	-2.6
One-year freeze in civilian agency pay raises a/	-1.0	-1.6	-1.7	-1.8	-1.9
Debt service savings	-0.9	-3.1	-5.9	-8.9	-12.0
Total changes	-20.1	-31.4	-37.2	-41.7	-46.0
Resulting Deficit	156	136	120	109	88

SOURCE: Congressional Budget Office.

a. These calculations are net of offsets for employer payments to employee retirement funds.

b. These calculations exclude means-tested programs.

activities can be left to the private sector, to other levels of government, or financed wholly through user fees. But other federal activities are extremely unlikely to be so assigned; in these instances, the federal government is the sole practical provider and, if it is to reduce the deficit, it must simply reduce public consumption, or do less.

Solely federal activities are generally those in which all citizens share, and often those from which no citizen can be excluded. These so-called public goods include, for example, national defense, basic scientific research, and energy security. A related class of activity provides assistance to a specific group to achieve some larger social goal. For example, farm benefits are paid to farmers, and cash payments and food stamps are provided to eligible poor people, to secure a variety of policy goals. Here again, it is unlikely that state, local, or private efforts could replace the now dominant federal role.

An advantage of this strategy is that, because of the collective nature of many of these activities, the burden of deficit reduction is broadly shared throughout society. The corresponding disadvantage is that, since the federal government is the sole practical provider of these activities, this approach entails a higher level of risk. Reductions in many nondefense discretionary programs may be balanced by greater efforts by private actors or other levels of government. But citizens have no recourse if they prefer higher levels of defense, space exploration, or income redistribution and the federal government decides to provide less of each.

Examples of this type of reduction can be found in almost all budget functions. Reducing funding for military research and development, including the Strategic Defense Initiative (DEF-11), would save $2.7 billion over the next five years, from 1989 through 1993. 1/ Reducing funding for military construction projects (DEF-15) would lower expenditures by $1.6 billion over the same five-year period. Eliminating the NASA space station (NDD-04) or the Superconducting Super Collider (NDD-06) would produce five-year savings of $10.6 billion and $2.2 billion, respectively, over the next five years, when compared with the Administration's budget request.

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1. DEF-11 referes to the eleventh deficit reduction option in the National Defense chapter of this volume. See the Contents page.

Other examples involve curtailing programs that redistribute income or use income payments to achieve other goals. For example, reducing the deficiency payments made to farmers as part of agricultural commodity programs (AGR-01) could produce five-year budget savings of $7.7 billion. Modifying the provisions of the Aid to Families with Dependent Children (AFDC) program (ENT-18) would reduce outlays by up to $2.3 billion over the next five years. Reducing federal funding for the arts and humanities (NDD-29) would save $0.9 billion over the same five-year period. In all of these instances, reductions in federal efforts are unlikely to be balanced by greater private or state initiatives.

Reassign Responsibilities

Economic and social programs are initiated at the federal level for a variety of reasons. States may lack the resources or expertise needed to enact programs; uniformity, coordination, or centralization may be a virtue (often when the scale or the effects of projects transcend individual states); or the desire to avoid a ruinous competition among the states may be paramount. Federal efforts in infrastructure and environmental policy all were superimposed over existing state and local programs during the postwar period for almost all of these reasons. In other areas, such as student aid and housing, few if any such programs existed, and state and local efforts largely followed those of the federal government.

At issue is whether these programs still require a pervasive federal financial or managerial role. Once a national system of facilities (such as roads or airports) is constructed, the federal government may no longer have an inherent advantage in maintaining it or financing its maintenance. Alternatively, environmental programs, housing, or infrastructure finance were sometimes undertaken at the federal level because other jurisdictions lacked the technical resources or incentives to administer them. But the existence of these federal programs has forced state and local governments to develop their own bureaucracies in these areas, and they are now often far more competent than they were when these federal efforts began.

Thus, the advantage of this strategy of relegating responsibilities is that, in some programs, state and local governments may make more efficient choices than would the federal government, given their proximity to local conditions. This facility could lead to better program decisions, thereby producing genuine economic gains. To the extent that federal program management or financial aid restrictions disregard local factors or arbitrarily restrict entire classes of projects, the advantage of this strategy will be greater.

But if programs involve significant regional spillovers or require national coordination, then delegating program responsibility may be harmful. Moreover, merely shifting spending responsibilities from the federal government to states and localities will not necessarily reduce aggregate spending; the budget "savings" credited to the federal government may be undone by added state and local spending. And shifting responsibilities will redistribute the financial burden, as federal assistance, financed in part by the relatively more progressive federal individual income tax, would be replaced by user fees or the state and local tax base.

A further concern when considering this strategy is that state and local governments must have sufficiently strong incentive and ability to accept new responsibilities. States will vary in this regard as do the programs themselves. States may have greater incentives, for example, to provide services such as education and infrastructure that underlie economic development and, therefore, create local benefits, than to provide social insurance or other redistributive devices. States may also differ in their financial condition and, therefore, their ability to respond to changes in federal effort.

This deficit reduction strategy can be found in a variety of options in this volume. Eliminating federal assistance for construction of wastewater treatment plants (NDD-13) would make financing these facilities strictly a state and local matter, producing federal savings of $4.1 billion over the next five years. Reducing federal capital grants for mass transit (NDD-20) would have the same effect, leading to a five-year deficit reduction of $1.8 billion. Increasing the state share of AFDC, Food Stamp, and Medicaid costs (ENT-16) would save up to $33.3 billion over the next five years.

Giving more responsibilities to state and local governments can also be accomplished through the tax system. The Tax Reform Act of 1986 eliminated the deductibility of state and local sales taxes from the federal personal income tax base. Eliminating the deductibility of other state and local taxes from the federal income tax (REV-15) would end a tax incentive that allows state and local taxpayers to bear less than the full cost of state and local government programs. Such a change would produce five-year savings of about $124.6 billion. Similarly, the federal tax code subsidizes state and local governments by exempting interest paid on their securities from federal personal income taxation. Eliminating the use of newly issued tax-exempt municipal bonds for private purposes (REV-08) would result in about $3.3 billion in new revenues over the next five years.

Improve Efficiency

Improving the efficiency of federal programs allows public policy goals to be promoted at a lower economic cost. Efficiency can be improved through deficit reduction options that aim to improve the management of federal programs or the incentives created by those programs.

The advantages of efficiency in federal programs are obvious; efficiency measures the productivity with which scarce federal resources are brought to bear on policy goals. But the corresponding difficulty in promoting efficiency as a deficit reduction strategy is that sometimes it is not clear what is efficient. The returns to federal programs are often broadly cast, difficult to calculate, and their identification is contentious. For example, mass transit projects often result in large cash losses, but may reduce downtown congestion that would be far more costly because of traffic delay and pollution. Alternatively, flood-control projects credit themselves with saving homes and businesses, but it is unlikely that all of these activities would remain on endangered flood plains were there no federal projects. Similarly, defense analysts often disagree about the significance of various threats to the nation's security and, therefore, about what constitutes an efficient defense. A further difficulty with carrying out this strategy through legislation is that the efficiency of many federal programs is determined at the managerial and administrative level and may, therefore, be a responsibility of the Executive Branch.

Nevertheless, some programs may cost more than they need to if the rules under which they are managed lead to uneconomic or inefficient decisions. For example, the use of fixed rates based on diagnoses, rather than cost reimbursement, already in place for Medicare and military personnel, could be extended to the health care system for federal employees (FWF-05) at a five-year savings of $1.5 billion.

Other programs could be changed in a fashion that provides incentives that are more compatible with their intent. For example, raising the initial cost of unemployment to the worker by requiring a two-week waiting period before unemployment insurance benefits are paid (ENT-14) could produce five-year budget savings of approximately $5.0 billion. Basing the state share of mineral receipts on a net, rather than gross, revenue basis (NDD-09) would produce savings of $1.3 billion over the next five years. Efficiency options can also be found in the national defense area. Closing selected military facilities (DEF-19) could allow the military to lower costs without reducing the effective level of defense at a five-year saving of $1.2 billion.

Efficiency can also be pursued through the tax system. Doing so generally involves options that broaden the base of certain taxes, thereby eliminating distinctions among various activities. For example, the deductibility of home-mortgage interest payments may lead to overinvestment in owner-occupied housing compared with other assets. Capping the amount of deductible home-mortgage interest at $20,000 for a joint return (REV-14) would raise $10.3 billion over the next five years. Creating comparable treatment among firms and industries can also lead to greater efficiency. For example, eliminating any one of the preferential treatments afforded the extractive industries--the expensing of intangible drilling costs, the percentage depletion allowance, and the passive loss exception--(REV-07) would raise federal revenues by up to $5.9 billion over the next five years.

Make the Prices of Goods Reflect Their True Costs

A variety of federal programs provide services to identifiable users at a price substantially below the service's cost or replacement value. Charging prices based on full costs or replacement costs could raise substantial amounts of revenue (often in the form of offsetting receipts) for the federal budget.

Many federal subsidies have been consciously tendered to promote regional development, various commercial activities, or humanitarian or social goals. But eliminating these subsidies can be economically beneficial when they are unintended or have outlived their original intent. Other subsidies may have grown in scope since they were established. And the demand for subsidized services may increase as growing numbers of users avail themselves of the benefits. In all these cases, forcing users of federal services to confront the true costs of their activities will lead them to use federal resources more efficiently. Moreover, since subsidies often lead their recipients to demand more federal services, eliminating them may reduce perceived future spending needs.

Eliminating subsidies, of course, occurs at the expense of the targeted group or individuals. During the transition period, recipients who have come to depend on subsidized federal services may experience difficulty. Another disadvantage of full-cost pricing is that federal subsidies are often not wholly enjoyed by those who will pay higher prices when the subsidies end. Public power or water supply subsidies, for example, are commonly incorporated in land prices, and may have been absorbed by earlier landowners long ago with the expectation that these subsidies would continue indefinitely.

Many deficit reduction options in this volume relate to this strategy. Ending direct and indirect postal subsidies (NDD-16) would save $2.3 billion over the next five years. User fees could also recoup the costs of recreational use of public lands (NDD-11), harbor maintenance (NDD-12), or commercial use of public land (NDD-10), producing five-year budget savings of $0.6 billion, $1.4 billion, and $0.8 billion, respectively. User fees could also be enacted for various federal credit activities by charging fees for federal below-cost loans or loan guarantees. Raising the current loan fees for Veterans Administration guaranteed housing loans (ENT-26) and for the Rural Electrification Administration (NDD-07) would raise $1.4 billion and $2.5 billion, respectively, over the next five years.

A group of tax options parallel the concept of full-cost user fees. These taxes attempt to make the prices of goods more representative of social costs. For example, proponents of an oil import fee point to the costs of defending the Persian Gulf and, at a minimum, filling the Strategic Petroleum Reserve as a consequence of the nation's dependence on oil imports; an oil import fee forces users of imported oil to confront these costs. An oil import fee of $5.00 per barrel (REV-23) would result in five-year revenues of $40.8 billion. Similarly, taxes on cigarettes and alcohol may be justified by the public health costs associated with them. Taxing beer and wine at the rate implied by the tax on distilled spirits or raising the tax on cigarettes to 32 cents per pack (REV-24) could produce $20.7 billion and $14.9 billion in new revenues over the next five years, respectively.

As is the case with full-cost pricing of federal services, the general advantage of these tax options is that they may force the consumers of these services to face the true cost of their consumption and, therefore, tailor their demands accordingly. But if the tax involved exceeds the social cost it is designed to correct, then the economic losses may be greater than had the tax not been put into effect.

Distribute the Burden to Those Who Can More Easily Pay

Another theme found in the deficit reduction options described in this report is to reexamine spending and tax policies with an eye to their redistributive effect; in other words, to move the burden to those who are more able to pay. One way to carry out this strategy is to increase the burden of taxes on higher-income groups. A second approach is reflected in deficit reduction options that emphasize what is sometimes called "horizontal equity"; that is, the equal treatment of equals. A third way is to target benefits more precisely or to relate more closely the net benefits received by the individuals and groups to their needs and circumstances.

The advantage of these options is that they may allow the deficit to be addressed while holding to a minimum the human hardship associated with spending cuts and tax increases. The ability to pay has long been considered a basis for taxation. Added progressivity in the tax system and in spending programs, however, entails a variety of risks. Some critics claim that progressivity in the tax system blunts the impetus to produce and earn, and that higher marginal tax rates lead to self-defeating losses in economic output. Redistributive spending programs are similarly criticized as establishing an underclass of the poor who come to depend on welfare programs for sustenance. The arguments and counterarguments regarding progressivity and redistribution can be seen in the following context: there is certainly some tax rate so confiscatory or the benefits of some social programs so unconducive to effort that they genuinely retard economic progress, just as there is a tax rate so low and social benefits so small that marginal increases in them do not disuade work. Current tax and spending practices probably lie between the two.

The first strategy--increasing the burden on the more well-to-do--could be carried out, for example, by raising the marginal tax rate to 33 percent for the highest income families (REV-01). This increase would raise five-year revenues by $29.6 billion. Alter-natively, taxing capital gains on the final income tax return of a decedent (REV-10) would raise $21.1 billion in five-year revenues.

A second approach is to tailor policies so that people of equivalent circumstances are treated equally. For example, horizontal equity could be pursued by eliminating the distinctions still made among different types of income. Under current law, many employer-provided fringe benefits are not taxed while wage and salary income is. Taxing employers' contributions for employees' health insurance (ENT-13) would raise up to $106.4 billion over the next five years.

A final approach is to target more strictly the benefits (or net benefits) received by groups or individuals. For example, Medicare benefits could be targeted further by taxing a portion of them as income (ENT-11), which would realize five-year budget savings of up to $33.3 billion. Reducing child nutrition program subsidies for children from families not defined as poor (ENT-15) would lower five-year outlays by $1.7 billion. Farm deficiency payments could also be targeted more strictly by restricting price support eligibility and lowering the payment limitation (AGR-03), which would lead to budget savings of $1.8 over the next five years.

Increase Taxes to Balance Public Expenditures

Just as one interpretation of persistent budget deficits is that the public is unwilling to finance all of the current expenditures it receives from the federal government, another is that it is unwilling to curtail further federal spending. If such is the case, then taxes must be increased to balance public expenditures.

The advantage of this strategy is that it promptly addresses the deficit and forces taxpayers to confront the true cost of the services they receive from the federal government. Seen in this context, the failure to raise taxes, by masking the true cost of the goods and services in the federal budget, reduces the public level of support for stricter spending cuts. Opponents of a tax increase, however, note that using tax increases to balance the budget may delay the program-by-program review that could lead to greater deficit reduction through spending reductions.

Revenue-raising options can generally be classified as increases in excise taxes or user fees, options to broaden the base of the existing (individual and corporate) income taxes, increases in existing rates, or new forms of taxation. User fees and some excise taxes are intended to align the prices of goods more closely with their costs; they include so-called "sin" taxes (such as those on alcohol or cigarettes) and an oil import fee. Options to broaden the bases of taxes are intended to promote the equal treatment of equals and the efficient use of resources, and include capping home-mortgage interest, counting fringe benefits as income, and eliminating the special treatment afforded some industries or groups. These options were discussed in previous sections of this chapter.

Options to raise existing tax rates--for example, the rates now found in the personal and corporate income taxes--are designed to finance (and, therefore, maintain) current expenditures. Raising the marginal tax rates now found in the income tax from 15 percent and 28 percent to 16 percent and 30 percent would raise revenues by $147.4 billion over the next five years. New five-year revenues of $109.1 billion could be achieved by a 5 percent surtax on individual income tax liabilities. An increase in the marginal corporate income tax rate to 35 percent would increase federal revenues by $13.3 billion over the next five years. (For all these estimates, see REV-01.)

The fourth class of revenue-raising options is to institute an entirely new tax. One such option is a new consumption tax, which would address what some analysts perceive as an imbalance favoring consumption over saving in the current income tax. A leading variant on this type of tax is a value-added tax (or VAT), which would be collected at each stage of production as a percentage of total sales, with sellers allowed a credit for taxes paid on goods or materials they purchase. The total tax base of such a tax would be equal to the value of all retail (or final) sales. A 5 percent VAT (REV-22) would raise between $265 billion and $459 billion over the next five years, depending on the types of consumption goods included in its base.

OTHER CONSTRAINTS

In determining the content of a deficit reduction package, the Congress must be concerned with more than the policy themes discussed above. In fact, when establishing the National Economic Commission, the Congress directed it to consider deficit reduction strategies within a group of constraints, including their effects on regional economic activity, the income distribution, and savings and capital formation. This section briefly discusses these constraints.

Regional Considerations

Many deficit reduction options assign a disproportionate burden to one region of the nation. An oil import fee, for example, will have greater effects in the Northeast than in other parts of the nation. Options concerning farm programs, water project development, or extractive industry (primarily oil and gas) tax preferences all have obvious regional implications. Still other deficit reduction options--such as not producing timber at a loss from specific national forests or eliminating prospective Navy home ports on the Gulf and Pacific Coasts--are explicitly tied to individual regions.

Redistributive Effects

While the desire to change the income distribution motivates a number of deficit reduction options, virtually all options have a redistributive effect. For example, excise taxes, by raising the prices of goods, may be somewhat regressive, since the less well-to-do spend a larger share of their incomes on all forms of consumption. Similarly, shifting responsibilities to state and local governments would substitute the generally less progressive taxes of these levels of government for the more progressive federal individual income tax as a source of financing for public services. And changing the terms on which any federal program is transacted will have some effect on income distribution, if only by changing the well-being of program beneficiaries.

Effects on Savings and Investment

Part of the economic danger associated with budget deficits is their pernicious effect on national saving. Indeed, increasing societal saving is an important motivation for reducing the federal budget deficit.

This concern is obviated to the extent that federal programs lead to productive investments rather than current consumption. If the federal government borrows to finance investment, rather than consumption, then it leaves society with a higher level of wealth and, therefore, greater wherewithal to repay those who financed the deficit. According to this view, options that cut current consumption but retain investmentlike programs are to be preferred.

Part of the difficulty in putting this principle into practice is that it is sometimes difficult to determine which federal programs actually do result in investment. Cases can be made for programs in the areas of research and development, defense, education, and infrastructure, among others. Nonetheless, the Congress must consider the effects its deficit reduction proposals will have on the economy's long-term prospects for growth.

Options can also be evaluated in terms of their effects on saving. If a higher societal level of personal saving is sought, then options that explicitly discourage consumption, such as the value-added tax or limitations on the home-mortgage interest deduction, may have advantages. Similarly, spending options may differ in terms of their effect on savings. For example, options that lead other levels of government to increase their spending by transferring to them added responsibilities may not change aggregate public spending or, therefore, total saving. These options may be less advantageous than options that eliminate spending that will not be replicated elsewhere in the economy, such as defense spending or some social programs.

CHAPTER III

NATIONAL DEFENSE

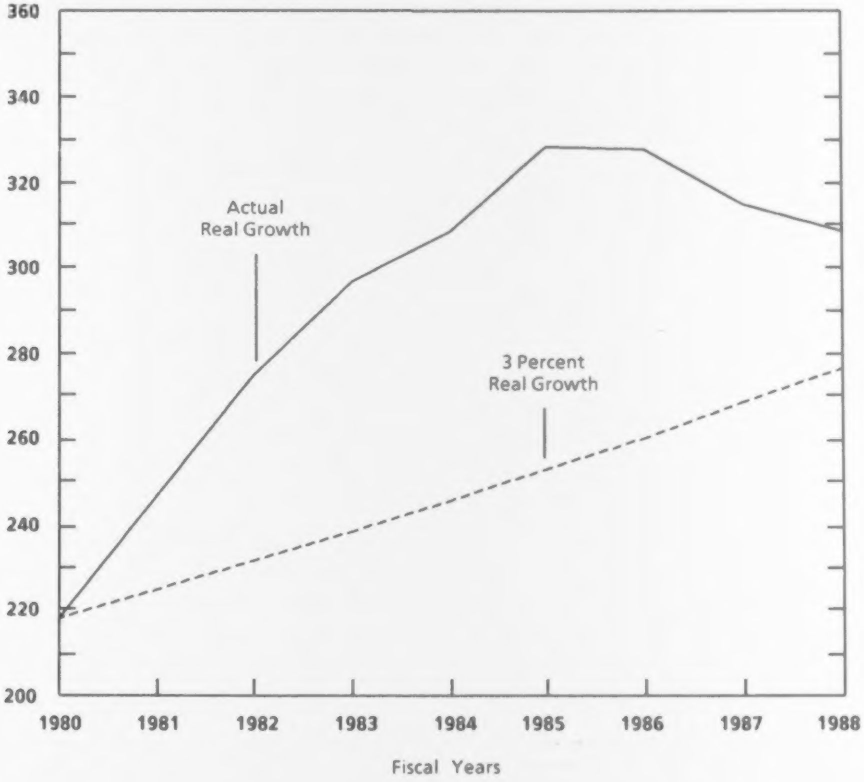
The national defense portion of the federal budget supports two major activities: developing and procuring equipment for the armed forces and paying personnel to operate and maintain this equipment. In 1988, about 54 percent of the budget authority in the national defense function will be spent for personnel and for operation and support of the forces. The remaining 46 percent, referred to as the "investment accounts," will fund the research and development, procurement, and military construction associated with military equipment. From another perspective, national defense spending is devoted to several military purposes (so-called "missions"), with general-purpose forces (that is, all those except strategic nuclear forces) receiving the largest share. Although spending for strategic nuclear forces often generates substantial debate, it will account for only about 11 percent of the total defense budget in 1988, according to Administration estimates.

Budget authority for national defense in 1988 totaled $291.4 billion, a real (or inflation-adjusted) decline of 2 percent from the 1987 level. (Estimates of real growth use CBO's economic and technical assumptions and so differ from the Administration's estimates.) This represents the third consecutive year of real decline in national defense budget authority following six consecutive years (1980-1985) of substantial real growth. During the growth years, real budget authority for national defense rose more than 50 percent. Soaring deficits increased pressure to reduce all government spending, including spending on national defense, leading to a real decline of 6 percent from 1985 to 1988. Still, national defense budget authority for 1988 remains $30 billion above the level that would have been expected if the United States had sustained an annual level of 3 percent real growth from 1980 through 1988 (see Figure 3).

The Administration's 1989 Defense Request

The Administration's 1989 request of $299.5 billion in budget authority for national defense represents a real decline of almost 3 percent relative to the 1988 level and is 10 percent below the projected 1989 level in the Administration's two-year (1988-1989) defense budget that was submitted to the Congress in January 1987. This new

Figure 3.
Defense Budget Authority, 1980-1988
(In billions of 1989 dollars)



SOURCE: Derived by Congressional Budget Office from historical budget data.

level, however, is consistent with that contained in last November's deficit reduction agreement between the Congress and the Administration. Beyond 1989, the Administration projects that the national defense budget levels will increase at an average annual real rate of 1 percent under CBO's economic assumptions (see Table 5). Relative to the CBO baseline, which assumes zero real growth in defense budget authority above the 1988 level for each of the next five years, the Administration's request is $8 billion lower in 1989. During the five-year period 1989 through 1993, however, the Administration's request exceeds the CBO baseline by a total of $1.5 billion.

Reducing the Deficit

Reducing the deficit will most likely remain a priority of the Congress for the near future. Further reductions may be needed in the 1989 defense request, particularly if economic conditions cause projected

TABLE 5. ALTERNATIVE LEVELS OF DEFENSE SPENDING (By fiscal year, in billions of dollars)

	Actual	Estimated	Projected				
	1987	1988	1989	1990	1991	1992	1993
			CBO Baseline a/				
Budget Authority	287.4	291.4	307.5	320.4	333.4	347.2	361.4
Outlays	282.0	287.1	295.2	306.3	319.7	332.6	345.2
			Administration's Request b/				
Budget Authority	287.4	291.4	299.5	316.4	333.7	351.6	370.2
Outlays	282.0	285.4	294.0	306.2	320.2	335.4	351.3

SOURCE: Congressional Budget Office.

a. The CBO baseline maintains real defense budget authority at the zero growth level throughout the five-year period from 1989 through 1993, using CBO's economic assumptions. Outlays are computed using historical spending patterns.

b. The Administration's request is from *Budget of the U.S. Government: Fiscal Year 1989*, and other documents from the Office of Management and Budget.

deficits to worsen. Moreover, the modest real growth in defense budget authority requested by the Administration beyond 1989 might not be possible. Even though the Administration has canceled some procurement programs and accepted reductions in personnel levels in the Army and Air Force, greater reductions might be necessary. If so, the Congress might wish to consider reductions in 1989 that, while leading to only modest savings in 1989, would offer greater savings in 1990 and beyond.

Reduce Number of Units. Reducing the number of units--people and weapons--in the armed forces would achieve only modest savings in 1989 but could result in significant savings in later years. Future personnel costs would be lower because there would be fewer people to pay; operation and maintenance costs could be lower because there would be fewer people to train and less equipment to maintain; and procurement costs could be lower because the smaller forces would need less equipment.

Having fewer units may be consistent with recent reports. A report titled *Discriminate Deterrence*, released in January by the Administration's Commission on Integrated Long-Term Strategy, implied that a reduced number of forces might be preferable to reductions in future force modernization. Indeed, the Secretary of Defense has proposed even fewer forces for 1988 than the Congress authorized.

Cancel Major Weapons. Canceling major development and procurement programs is another strategy that might offer greater future savings. The annual costs associated with major programs--and the savings associated with terminating them--tend to increase as programs advance through development and production stages. Greater near-term savings can usually be achieved by canceling programs in production than by canceling programs in development. But, canceling major programs once an initial production decision has been made has been very difficult to do in the past. Thus, to achieve annual savings once programs advance beyond development, the tendency has been to stretch procurement over a greater number of years by buying less in each year. A recent CBO study suggests that this strategy, although saving money on an annual basis, often costs more in the long term.

SPECIFIC OPTIONS

This section presents 26 specific options to limit spending for national defense. The first 10 alternatives offer lower spending levels by reducing the rate of growth in procurement programs for major systems, such as the small intercontinental ballistic missile, the F-15 aircraft, the SSN-688 submarine, and the V-22 tilt-rotor aircraft. Savings would be achieved either by canceling systems, as in DEF-04 and DEF-08, or by deferring initial procurement, as in DEF-09.

Options DEF-11 through DEF-16 consider limits on spending in other military investment accounts. Over the next five years, the Administration plans to spend large amounts in areas such as research and development and military construction. Options discussed here would achieve savings by sharply reducing the growth in some programs, such as the Strategic Defense Initiative or the Navy's plan for new home ports for its ships.

Reducing the number of military forces and limiting further improvements in readiness are discussed in DEF-17 through DEF-21. Although limiting growth in military forces would provide only small savings in the first year, these options would produce substantial savings once the options were fully implemented.

Finally, DEF-22 through DEF-26 offer savings by limiting the growth in pay and benefits for military personnel--for example, by slowing pay increases for active-duty personnel or by increasing cost sharing for medical care provided to military dependents and retirees.

The estimates of savings for all options were made relative to the Administration's proposed budget, using CBO's current economic assumptions. In many cases, only the Administration's budget contains the detail necessary to estimate savings for specific program options. Where possible, however, savings relative to both the Administration's budget and the CBO baseline are provided.

DEF-01 CANCEL PROCUREMENT OF THE F-15

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	1,600	1,600	1,500	1,300	1,200	7,200
Outlays	140	720	1,170	1,280	1,280	4,590

The F-15 is the Air Force's premier fighter, capable of operating during day or night and in inclement weather. Its long-range radar and medium-range missile enable the F-15 to attack enemy aircraft before those aircraft can detect and attack the F-15. The Administration plans to purchase 36 of these aircraft in 1989 and 30 in each of the four years thereafter. Because of the plane's expense, however, the Air Force developed the less capable, but cheaper, F-16 to fulfill its total force requirements. The Air Force will have purchased about 1,680 F-16s by the end of 1988 and plans to acquire an additional 180 aircraft in 1989. Firm plans beyond 1989 are not available.

Canceling all further development and procurement of the F-15 would save nearly $1.6 billion in budget authority in 1989 and about $7.2 billion over the next five years. During this period, the Air Force will continue to develop the Advanced Tactical Fighter (ATF). According to design specifications, the ATF, which is intended to begin replacing the F-15 in the mid-1990s, should be superior to the F-15. Thus, if the ATF can meet all of its design objectives and enter the force as currently planned, it could provide the United States with a significant increase in tactical aircraft capability. Canceling the F-15 program would provide a greater degree of certainty that the ATF program would be funded as planned if the overall budget for Air Force tactical fighters were further constrained.

The Air Force can also meet its current goal of 35 tactical fighter wings without additional F-15 purchases and without changing current retirement plans for the F-4s. Canceling the F-15 would, however, reduce overall U.S. capacity to produce aircraft--a potential problem in a lengthy war. Furthermore, the Air Force would acquire fewer than 100 F-15Es--an improved version of the F-15 that the Air Force is now buying for its ground attack mission. This number might be too low to allow military planners sufficient flexibility for employing the aircraft in the broad range of ground attack missions for which it was developed.

DEF-02 RESTRUCTURE THE ARMY'S FORWARD AREA AIR DEFENSE PROGRAM

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	120	400	390	400	390	1,700
Outlays	-20 a/	40	200	320	360	900

a. Research and development appropriations spend at a faster rate than those for procurement. Outlay costs in 1989 for developing a missile described in this alternative exceed outlay savings associated with canceling ADATS and Chaparral in the same year.

Following the cancellation of the Sergeant York Division Air Defense Gun (DIVAD) in August 1985, the Army initiated a program to improve its ability to defend troops positioned well forward in the battle area against enemy aircraft, particularly helicopters. This Forward Area Air Defense (FAAD) program contains five elements designed to: (1) improve communications among air defense weapons and sensors; (2) purchase a new weapon to perform the mission of the canceled DIVAD; (3) develop and procure a system, commonly known as the pedestal-mounted Stinger, to provide air defense for the rear of the battle area; (4) develop and procure a system to attack enemy helicopters hiding behind hills, trees, or buildings (a non-line-of-sight system); and (5) improve the air defense capability of the Army's existing helicopters, tanks, and fighting vehicles. Reports indicate that the total cost of this five-part program could be as much as $12 billion, about $7 billion of which would be required through 1991.

This alternative considers a restructured FAAD program, with the emphasis shifted from sophisticated and expensive "dedicated" (that is, devoted to a single purpose) air defense weapons to programs designed to upgrade Army tanks, fighting vehicles, and helicopters with a capacity to provide protection from enemy aircraft. Since the principal threat to the Army's forward area comes from helicopters, the program would emphasize providing all Army weapons with some ability to destroy enemy helicopters. For example, each fighting vehicle would be equipped with missiles that could be used against either tanks or helicopters, Army helicopters would be equipped with missiles capable of destroying enemy helicopters, and Army tanks would be provided ammunition with enhanced capability against hovering helicopters.

Because each Army vehicle would be capable of defending troops against enemy helicopters, dedicated air defense weapons should be needed primarily to counter fixed-wing aircraft. The Stinger missile system, currently in use by the Army, is designed to oppose fighter-bomber aircraft. A vehicle-mounted version of Stinger, which is being developed as part of the FAAD program, could replace the older Chaparral system currently in the field and would provide needed capability. Savings under this alternative would be $120 million in budget authority in 1989 and $1.7 billion over the next five years. Savings reflect termination of the Air Defense Antitank System (ADATS) program, recently selected by the Army as the follow-on to the DIVAD program, and cancellation of further purchases of Chaparral missiles and fire units, offset by the costs of developing a missile to give the Army's fighting vehicles an air defense capability.

This alternative might also offer increased capability, relative to the Army's plan, in at least one area. The ability to destroy helicopters is, in part, a function of the total number of weapons that are capable of striking helicopters at a specific range. By this measure, this option could eventually provide twice as much capability as the Army's plan.

On the other hand, this alternative requires that infantry and tank commanders assume greater responsibility for air defense, a situation that could adversely affect their ability to perform their mission of destroying tanks.

DEF-03 CANCEL DEVELOPMENT OF THE V-22 AIRCRAFT

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	640	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	190	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1989 Department of Defense budget amendment does not provide sufficient detail to compute annual savings beyond 1989 for this alternative.

The V-22, previously known as the JVX, is a new tilt-rotor aircraft being developed by the Department of the Navy for use by all four services. (A tilt-rotor aircraft has rotor blades that can be positioned vertically for taking off and landing, and horizontally for forward flight.) The aircraft will be designed to transport 24 people or about 5,700 pounds of equipment at cruising speeds of over 280 miles per hour. Its long maximum range of 2,400 miles should allow it to fly to Europe in the event of war, thus freeing large transport aircraft and amphibious ships for other cargo.

The V-22 aircraft is expected to perform different missions for each of the four services. The Marine Corps has expressed the largest and earliest need, asking for 552 aircraft with delivery beginning in the early 1990s. These aircraft would be used for combat assault--that is, transporting troops and equipment from an amphibious ship to a beachhead--a mission now being fulfilled by the aging CH-46 and CH-53 helicopters. Air Force requirements call for 80 aircraft in the 1990s for special operations, while the Navy has indicated a need for only 50 aircraft to conduct combat search and rescue. Recent press reports indicate that the Army has withdrawn from the V-22 program.

Canceling further development and procurement of the V-22 could save an estimated $640 million in budget authority in 1989. Additional savings would be realized in later years. The Marine Corps could continue to rely on the older and less capable CH-46 and CH-53 helicopters, while considering other helicopters and amphibious landing craft to perform combat assault missions in the future. Relying on these older helicopters should not cause operational problems at the present time. The Marine Corps has indicated that, by continuing to replace parts subject to wear, helicopter service lives can be extended indefinitely. The relatively small needs of the other services could also probably be met with other existing helicopters or small fixed-wing cargo aircraft.

Termination of the V-22 also could reduce the number of aircraft models competing for Navy aircraft procurement funds. The Congress is already concerned about the number of Navy aircraft programs now funded at low procurement rates. Thus, if the Navy had to rely on existing aircraft in lieu of the V-22, these aircraft might be procured at more economic production rates, or at least might not be reduced below the currently planned rates.

DEF-04 TERMINATE EARLY THE SSN-688 SUBMARINE PROGRAM

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	1,580	1,600	1,400	840	n.a.	n.a.
Outlays	80	320	640	860	n.a.	n.a.

NOTE: The Department of Defense did not provide sufficient detail to compute annual savings beyond 1992 under this alternative.

The Los Angeles-class nuclear-powered attack submarine (SSN-688) has been the Navy's premier attack submarine for the past decade. Its wartime missions include detecting and destroying enemy submarines and surface ships, protecting U.S. naval forces and shipping, and attacking land-based enemy targets with nuclear or conventional cruise missiles. The Navy's inventory now includes 37 SSN-688s, and an additional 22 have been authorized for construction but have not yet been delivered. Navy plans call for purchase of another seven SSN-688s through 1992.

Production of the SSN-688 is scheduled to terminate in the early 1990s as a new nuclear-powered attack submarine, the SSN-21, begins to enter the fleet. Initial construction funds for the first SSN-21 were authorized in 1987, and the ship will probably enter the fleet in 1995. The performance specifications for the SSN-21 indicate that it will be quieter, faster, and able to dive deeper than the SSN-688. In addition, the SSN-21 will carry more weapons than the SSN-688, and it will have improved sensors for hunting enemy submarines.

This option would terminate the SSN-688 program in 1989. Savings would total about $1.6 billion in 1989 and $5.4 billion over the next four years. Assuming the SSN-21 submarine is produced as scheduled, this alternative should not significantly affect the Navy's goals for its submarine force. The Navy's stated goal for all types of nuclear-powered attack submarines is a force of 100 ships. Assuming that older submarines retire after 30 years of service, CBO's projections show that the Navy's force of nuclear attack submarines will exceed 100 ships through the late 1990s. Indeed, even if all seven SSN-688s planned for production in 1989 through 1992 were canceled, the force would still have more than 100 nuclear-powered attack submarines through 1997.

Terminating the SSN-688 program early, however, would leave the Congress heavily committed to the SSN-21 before the first one has been produced, tested, and deployed. If costs of the SSN-21 grow to unacceptable levels, or capability falls, the only choice would be to cancel the program and start a new one. Even if they are successful, new weapons programs are commonly delayed. If the SSN-21 program is delayed, then the Navy's submarine fleet, which would number about 100 submarines under current plans for the SSN-21, could have fewer than 100 submarines by the year 2000. This decrease might be significant if Soviet improvements in submarine technology continue at the current rate and their submarines become increasingly more difficult to detect. This trend in Soviet submarine capability could lead to a Navy requirement for more attack submarines, not fewer.

DEF-05 CANCEL PROCUREMENT OF AMPHIBIOUS WARFARE SHIPS

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	770	350	1,300	650	n.a.	n.a.
Outlays	40	130	280	430	n.a.	n.a.

NOTE: The Department of Defense did not provide sufficient detail to compute annual savings beyond 1992 under this alternative.

As an integral part of its plan for a 600-ship Navy, the Administration increased the goal for Navy ships dedicated to transporting Marine Corps troops, cargo, vehicles, and aircraft. The Administration's plan was to provide sufficient "amphibious lift" to carry simultaneously the troops and equipment of the assault echelons of one Marine amphibious force (about 35,000 troops) and of one additional Marine amphibious brigade (12,000 troops). The current Navy inventory of amphibious warfare vessels stands at 63 ships--12 short of its goal of 75.

Between 1989 and 1992, the Navy plans to procure two additional Wasp-class (LHD-1) amphibious assault ships and four cargo variants of the Whidbey Island-class (LSD-41(CV)) of dock-landing ships. By canceling all amphibious warfare ships in the Administration's five-year shipbuilding plan, this alternative would save nearly $0.8 billion in 1989 and about $3.1 billion through 1992.

Some critics of the Navy assert that the United States can continue to meet its defense commitments by providing sufficient lift for the assault echelon of just one Marine amphibious force. This assessment assumes that the Navy would have the capacity to transport the equivalent of a Marine amphibious brigade in each of three locations--the Atlantic, the Pacific, and the Persian Gulf--at the same time. Critics also argue that the Marine Corps troops can be transported by airplane to link up with equipment prepositioned in Norway and on maritime prepositioning ships--floating warehouses for the Corps' equipment--around the world, thereby reducing the reliance on Navy amphibious assault ships for transport.

This option, however, would effectively halt progress toward achieving the Navy's goal for amphibious lift. The Navy will probably need to procure additional amphibious assault ships in the mid-1990s to replace older assault ships that will reach the end of their expected service life at the end of the 1990s, and disrupting the shipbuilding program for the LHD-1 class for several years could result in higher costs for replacement ships than if shipbuilding were to continue without interruption.

DEF-06 CANCEL TRIDENT REFIT PROGRAM

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	240	70	330	230	490	1,360
Outlays	30	100	150	230	270	780

The U.S. Navy is currently developing and buying a new submarine-launched ballistic missile (SLBM), the Trident II, for deployment in Trident submarines. This new missile will be deployed as original equipment in the ninth and subsequent Trident submarines. The Navy plans to refit the first eight Trident submarines, currently armed with Trident I SLBMs, to carry the Trident II. This option would cancel the plan to refit these submarines.

The Navy's rationale for the refitting program is based on the better accuracy and larger payload of the Trident II. Whereas the Trident I has moderate accuracy and carries eight Mark IV warheads, the Trident II will be roughly twice as accurate and will carry either about twelve Mark IV warheads or about eight, more powerful Mark V warheads. The improved accuracy of the Trident II missile and the alternative of employing larger warheads would greatly enhance U.S. capability to destroy enemy targets, such as Soviet silos for intercontinental ballistic missiles (ICBMs) and command and control centers, both of which are hardened to withstand nuclear blasts.

But the plan to refit the first eight submarines is expensive. Canceling the refits would save about $240 million in budget authority in 1989 and about $1.4 billion over the next five years. This alternative would also reduce the procurement of the Trident II by about 180 missiles, saving about $5 billion, although these savings would probably not be realized until the mid-to-late 1990s at the end of the Trident II procurement.

This option would preserve about 1,500 warheads capable of destroying softer targets instead of deploying about 1,900 new warheads with greater capability against hardened targets. Assuming that the United States deployed a fleet of 20 Trident submarines as currently planned, this change would not significantly affect the ability of the entire U.S. ballistic missile force--including both land-based and submarine-based missiles--to destroy either small (500) or large sets (up to 2,000) of hardened enemy targets. This change, however, would decrease by about 10 percent the portion of a large set of hardened targets that could be destroyed by U.S. SLBMs alone. The SLBMs might have to attack these targets alone if U.S. land-based missiles were destroyed by a Soviet attack.

DEF-07 CANCEL THE SMALL INTERCONTINENTAL BALLISTIC MISSILE PROGRAM

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	200	0	0	0	0	200
Outlays	110	70	10	0	0	190

In order to enhance the survivability of the land-based leg of the triad of strategic forces, the Administration, in last year's budget, planned to deploy 50 MX missiles on rail cars (in addition to the 50 now being deployed in existing silos) and about 500 small, single-warhead intercontinental ballistic missiles (SICBMs) on mobile launchers hardened to withstand nuclear blast. In periods of crisis, mobile systems can disperse over wide areas, making them difficult to destroy. In the 1989 budget amendment, the Administration has not included any funds for the SICBM beyond $200 million in 1989. This amount will preserve the option of continuing the program for the next Administration. The Secretary of Defense has also testified that, pending Congressional approval, the Administration plans on basing all 100 MX missiles on rail cars (Rail MX). This option would cancel the SICBM because of its high cost and rely instead on Rail MX. Savings would total $200 million in 1989.

Canceling SICBM would mean forgoing some capabilities. In peacetime, both the SICBM and Rail MX would be maintained in essentially fixed sites on military bases to minimize operating costs and avoid environmental problems. The SICBM would require about 30 minutes of notice that a Soviet attack was actually under way so it could disperse off-roads to achieve high levels of survivability. Rail MX would require hours of advance notice to achieve this same initial level of survivability because it would have to move along a limited number of fixed rail lines.

In addition to its independence from advance warning for survivability, SICBM may offer other advantages. The Air Force has stated that it has a requirement for single-warhead missiles in the ICBM force to provide flexibility in targeting isolated facilities and, presumably, to control escalation. Minuteman II missiles are the only single-warhead missiles currently available and, like other silo-based missiles, would probably not survive a Soviet attack. Moreover, at some point these older Minuteman II missiles would have to be replaced with new missiles. Without SICBM, yet another missile may have to be developed. Moreover, the SICBM on its launcher vehicle, which is hardened against nuclear blasts and able to travel off-roads, is more likely to survive during an extended conflict than is an MX missile on a rail car.

The advantages of SICBM, however, come at a significant price. Should the next Administration choose to continue the program, total program costs remaining to be appropriated would, based on last year's budget plan, total about $41.7 billion. Annual operating and support costs are almost three times those of Rail MX--about $600 million (in 1989 dollars) when the system is fully deployed. SICBM would, however, be more cost effective--in terms of dollars per surviving warhead--in the event of a surprise attack, or if Rail MX missiles were not dispersed for some other reason. But that event is considered less likely than an attack that occurs after warning.

DEF-08 CANCEL THE MANNED PENETRATING BOMBER PROGRAM

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
Savings from Admin. Request	1989	1990	1991	1992	1993	

The annual budgetary impact of this option cannot be provided because the program is classified.

The B-2 bomber, also referred to as the Advanced Technology Bomber (ATB) or Stealth bomber, is the second bomber program in the Administration's plan to modernize its bomber force. (The B-1B bomber was the first.) The B-2 is designed to be nearly invisible to Soviet radars, and so should be better able to penetrate the airspace of the Soviet Union. Once the B-2s enter the fleet, the older B-52 bombers would remain outside Soviet airspace and launch cruise missiles--small, highly accurate, unmanned aircraft--to attack their targets. The new B-1Bs would carry a mix of both cruise missiles and short-range weapons, and thus could both "shoot and penetrate."

The Administration believes penetrating bombers are needed to accomplish certain missions. One key mission is to find and destroy mobile Soviet targets--such as mobile missiles--a class of targets expected to grow significantly in numbers. Mobile systems, however, are generally thought to enhance stability and deterrence because they reduce the value of a preemptive attack and provide assured retaliatory capability. Furthermore, it is hard to evaluate how effective a manned bomber would actually be in search-and-destroy efforts occurring after a nuclear exchange.

This option would cancel the B-2 and rely on an alternative force of B-52s carrying cruise missiles and B-1B bombers carrying both cruise and short-range missiles. Fully arming this force would require additional procurement of about 1,200 advanced cruise missiles. Furthermore, since the B-52Gs would be retained longer than under the Administration's plans, they may require some additional modifications to increase reliability, sustainability, and maintainability.

The advantage of this option is that procurement savings could be substantial. The B-2 bomber program is a highly classified, "black" program; only the most aggregate information about costs and capability have been made public. Based on press reports of Defense Department statements, however, the total cost of developing and procuring the B-2 would be about $59 billion (in 1989 dollars). Most of these funds have probably not yet been spent, since the B-2 is not expected to have its initial operating capability until the early 1990s. There would, however, be some added costs under this option. For example, an additional 1,200 advanced cruise missiles would have to be procured, but costs are not publicly available for this program. When all the pluses and minuses are totaled, this option could probably reduce costs over the next decade by about $40 billion or more. A substantial amount of these savings would occur over the next five years and would markedly alter strategic costs.

Operating costs under this option could well increase, though again it is difficult to know by how much. Operating and support costs to maintain older, expensive B-52G bombers in the force until the year 2000 would total nearly $12 billion (in 1989 dollars). These added costs would be offset, because costs to operate and support a larger number of the B-2s would not be incurred under this option. Again, those costs are not publicly known, but they may not be sufficient to avoid a net increase in operating costs.

The overall effectiveness of the bomber force would probably be reduced under this option. Two penetrating bombers with different penetration characteristics as well as cruise-missile carriers would put greater stress on Soviet air defenses and provide more extensive target coverage. In the force structure under this alternative, only the B-1B bomber would still penetrate and presumably would focus on a smaller set of high-priority targets. The alternative force, however, would have more cruise-missile carriers and thus should be able to engage more targets whose locations are known. Moreover, the alternative force should have nearly as great a chance as the Administration's force of surviving an initial Soviet attack, a key factor in deterrence. Bombers on alert (that is, armed and ready to take off), even current bombers, have excellent chances of surviving a Soviet nuclear strike.

DEF-09 DELAY NEW PROGRAM STARTS ONE YEAR

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	690	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	160	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1989 Department of Defense budget amendment does not provide sufficient detail to compute annual savings beyond 1989 for this alternative.

Since 1985, the combination of reduced funding for defense procurement, the initiation of many new major weapons systems, and the failure to cancel ineffective or low-priority programs has contributed to reduced funding and higher costs for existing weapons systems. Delaying new research and development (R&D) and initial production of major weapons programs by one year, to 1990, could yield near-term savings and improve overall affordability for existing weapons.

This option identifies new Department of Defense (DoD) R&D and production programs planned for 1989. The Congress could choose to defer development or production of many or all of these new programs until 1990 to preserve the planned development and production rates of existing systems. Savings that result from deferring all new major program starts in R&D and procurement might be as much as $690 million in budget authority in 1989.

Production. Funding for defense procurement programs has decreased in real terms each year since 1985, dropping 1 percent in 1986 from 1985 levels, more than 12 percent in 1987 from 1986 levels, and 3 percent in 1988 from 1987 levels. Although the DoD's request for procurement funding in 1989 is approximately 9 percent below the 1988 appropriated level in real terms, the Congress may not be able to meet even this request.

Despite the recent real reductions in procurement funding, the Department of Defense has begun production of 20 major new weapons programs since 1985. Since few major weapons systems have been canceled during this period, budgetary reductions and funding for new programs have been accommodated by stretching out existing procurement programs. The costs of such stretchouts have been significant. For example, by reducing procurement of the F-15 from levels planned for 1983 through 1988, the unit cost of the aircraft has increased by 31.5 per-cent.

The amended President's budget for 1989 contains a request for $450 million in funding for three new production programs. All three programs are planned to begin serial production in 1989, including the new Air Defense Antitank System, the V-22 tilt-rotor aircraft, and the Tanker-Transport Training Aircraft. By delaying initial production of these programs, savings could approach $450 million in budget authority in 1989. Alternatively, the Congress could choose to cancel these programs (see DEF-02 and DEF-03).

Research and Development. The real rate of growth of R&D funding has slowed dramatically since 1985. Research and development appropriations grew 9 percent in 1986, only 2 percent in 1987, and actually fell 1 percent in 1988. Research and Development funds requested by DoD for 1989 are 1 percent lower in real terms than the R&D appropriations for 1988.

Still, recent R&D funding has accommodated 28 new major research and development programs since 1985. The 1989 President's budget requests $185.4 million for six new major R&D programs--the Advanced Antitank Weapon System, the Evolutionary Surface-to-Air Missile, the Follow-On Lance Missile, the Advanced Artillery Systems Demonstration, the Advanced Detection System, and the Long-Range Conventional Cruise Missile. Although the possible near-term savings from postponing these programs are limited, a delay could help to make existing research programs more affordable. Moreover, since many programs that have been started since 1980 are now approaching production, a delay of new R&D programs could help to moderate the increasing demands for scarce production funding in the future.

Delaying new R&D and production programs may temporarily forgo near-term planned improvements in military capability. Such losses, however, may be somewhat offset by avoiding stretchouts of existing research and production programs. At the same time, a delay may provide an opportunity to resolve technical problems and reduce production risks for the new programs currently planned for 1989.

DEF-10 LIMIT FUNDING FOR SUPPORTING PROCUREMENT

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Savings from Administration's Request						
Budget Authority	1,360	1,880	2,530	3,410	4,430	13,610
Outlays	365	910	1,560	2,255	3,065	8,155
Savings from CBO Baseline						
Budget Authority	2,200	2,290	2,380	2,480	2,580	11,930
Outlays	590	1,270	1,840	2,150	2,340	8,190

While most Congressional debate is focused on major acquisition programs for ships, aircraft, combat vehicles, and missiles, nearly one-fourth of the defense procurement budget goes to buy other equipment, such as computers, office equipment and furnishings, trucks and cars, communications equipment, and materials-handling equipment. These "Other Procurement" accounts--referred to here as supporting procurement--support the operational needs of the services both in the field and at headquarters. In terms of their importance to the services' missions, the type of equipment they fund range from essential military items such as sonobuoys and radios to items that support ad-ministrative activities both in peacetime and wartime, such as office computers.

In 1988, the Administration requested $20.7 billion for these accounts. The Congress reduced this amount to $19.2 billion, a 7 percent decrease from the amount requested. In its 1989 budget, the Administration has requested $19.2 billion for supporting procurement, about the same amount appropriated in 1988. This option would cut the 1989 request by $1.4 billion, a reduction of 7 percent--the same percentage cut the Congress imposed in 1988--and would maintain this level of funding, adjusted only for expected inflation, through 1993. A decrease of this magnitude would save $13.6 billion in budget authority over the next five years.

Reductions of this size undoubtedly will have some effect on military capability, but the exact effect would depend on where the cuts fell. Concentrating reductions on such items as communications equipment and trucks--equipment needed in combat--could affect the ability to support forces in wartime. On the other hand, if purchases of office equipment, training aids, and other items needed in peacetime were to bear the brunt of the cuts, readiness and administrative efficiency could suffer, as the services would be forced to continue using existing equipment and defer planned improvements.

DEF-11 REDUCE FUNDING FOR RESEARCH AND DEVELOPMENT

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Savings from Administration's Request						
Budget Authority	0	320	810	1,110	1,340	3,580
Outlays	0	170	530	880	1,140	2,720
Savings from CBO Baseline						
Budget Authority	360	370	380	400	420	1,930
Outlays	190	320	350	370	390	1,620

Research, development, test, and evaluation (RDT&E) appropriations for the Department of Defense (DoD) pay for a wide range of activities, from basic research to operational testing of developed systems. Basic and applied research is performed in technological areas relevant to military systems, such as lasers, communications, or integrated circuits. But basic research is a small component of the overall DoD research and development program: in 1989, basic research and exploratory development funds account for less than 9 percent of the RDT&E budget request. Most of the RDT&E funding (60 percent in 1988) is earmarked for development of new weapons and equipment; the remainder pays for weapons testing and for management and support of the research and development (R&D) process.

RDT&E budget authority has grown sharply in recent years, fueled in part by growth in the Strategic Defense Initiative (see DEF-14). In 1988, however, the Congress rejected the Administration's request for an 18 percent real increase in RDT&E funds and adjusted it downward, providing less than sufficient growth to offset the effects of inflation. The Administration's 1989 defense budget request includes $38.2 billion for RDT&E, an amount roughly 1 percent lower than the 1988 level after adjusting for expected inflation.

This option would freeze RDT&E funding at $38.2 billion per year (in constant 1989 dollars) over the 1989-1993 period. Savings relative to the Administration's request would be zero in 1989, but would total $3.6 billion over the five-year period. Savings relative to the CBO baseline would be $360 million in 1989 and $1.9 billion over the same five-year period.

More than 700 separate RDT&E programs are identified in the budget, and last year the Congress made changes to more than one-half of them. This option, therefore, cannot detail how the above reduction would be achieved, but the effect would be substantial. Freezing total RDT&E budget authority probably would mean that new development initiatives would be subjected to intense scrutiny, since this funding would have to come from reductions in the level of support to existing RDT&E programs. Determining the effect on military capability of deferring or canceling RDT&E programs is more difficult, because adverse effects from lower levels of RDT&E support would not manifest themselves for many years.

It is arguable whether technological advances that manifest themselves in new concepts for weapons come specifically from DoD-funded research or from the larger federal and private U.S. research efforts of which DoD basic research is a small part. Cuts in development programs, however, will directly affect the speed with which new weapons systems reach production status.

DEF-12 DELAY THE LONG-RANGE AIR ASW CAPABLE AIRCRAFT PROGRAM

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	0	470	660	790	n.a.	n.a.
Outlays	0	40	220	440	n.a.	n.a.

NOTE: The Department of Defense did not provide sufficient detail to compute annual savings beyond 1992 under this alternative.

A large part of the Navy's air antisubmarine warfare (ASW) effort is the responsibility of 39 land-based aircraft squadrons. These squadrons, which are stationed on both coasts of the United States and selected locations throughout the world, currently operate the Lockheed-built P-3 aircraft. Although the electronics equipment aboard the aircraft has changed several times through the years, the aircraft itself has remained relatively unchanged since it was first produced in the late 1950s.

The Navy recently asked aircraft companies to propose a new long-range air ASW capable aircraft (LRAACA). Because the Navy wants production to begin in 1990, contractors' responses to its request will have to be variants of existing aircraft. Proposals could include a modification to the current P-3 design or a derivative of a commercial transport aircraft.

This alternative would delay the LRAACA procurement by two years, allowing the Navy more time to define its overall antisubmarine warfare strategy and to investigate more fully the airframe options for the program. There would be no savings under this alternative in 1989; savings through 1992 would total $1.9 billion.

The Navy has said that the ASW mission is one of its highest priorities because of concerns about the dramatic quieting of Soviet submarines. Any change in ASW plans--including those for LRAACA--most likely will be viewed as a threat to future ASW capability.

The Congress, however, has expressed its concern about the coherence of the Navy's overall plan for the ASW mission. Both the House and Senate Committees on Armed Services directed the Navy to submit a master plan indicating its priorities for developing the many weapons that conduct antisubmarine warfare: land-based aircraft including LRAACA, sea-based aircraft, surface ships, and attack submarines. The House, in particular, expressed skepticism about the LRAACA program.

DEF-13 REDUCE FUNDING FOR THE NATIONAL AEROSPACE PLANE

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	90	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	40	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1989 Department of Defense budget amendment does not provide sufficient detail to compute annual savings beyond 1989 under this alternative.

In January 1986, the Department of Defense (DoD) initiated a joint effort with the National Aeronautics and Space Administration (NASA) to design and build a National Aerospace Plane that will be capable of delivering civilian and military payloads into orbit. The aerospace plane, or X-30 aircraft, is envisioned as an experimental hypersonic aerospace aircraft that will employ highly advanced propulsion, structures, and materials technologies. The first flight of the X-30 is planned for early 1994. The DoD and NASA have asked the Congress to provide $349.8 million in 1989 for continued research and development and initial production of two X-30 aircraft. Last year, the DoD estimated that the program would cost about $3.3 billion. Other independent estimates range as high as $17 billion.

The National Aerospace Plane is planned to be the technological basis for the nation's next generation of space transport for both civilian and military missions. According to current plans, the X-30 aircraft will be capable of horizontal takeoffs and landings using conventional airfields. It will use advanced technology engines called "scramjets" to cruise at high speed (4,000 to 6,000 miles per hour) in the earth's atmosphere, or to approach orbital velocity. At an altitude of about 40 miles, small rocket engines in the aircraft will take over to propel the plane into orbit. The plane's speed and ability to operate in space as well as in the earth's atmosphere may be the most important capabilities for various military missions.

The program planned for the X-30 aircraft, however, appears overly optimistic. Although the technologies involved currently are beyond the state of the art, the total time allowed between awarding contracts for the next phase and the first flight is only 40 months. This schedule compares with 53 months required for analogous development of the B-1A bomber during the 1970s, and 69 months for the experimental XB-70 bomber built during the 1960s. Moreover, although both the B-1A and the XB-70 involved high technological risks for their times, the X-30 program appears to be more ambitious, involving relatively more advanced technology. For example, although scramjets being designed for the X-30 have been tested to seven times the speed of sound in a wind tunnel, their top speed and efficiency (which determine their relative advantage over using rocket boosters) remain unknown.

This alternative would delay growth in funding for the aerospace plane. Specifically, this alternative limits funding in 1989 to zero real growth. Estimated savings would be $90 million in 1989.

This alternative would allow more time to resolve many outstanding issues such as the lack of adequate ground facilities to test structure and propulsion systems needed for hypersonic performance, which limits technical progress. Also, basic program missions, particularly future defense missions, have not been fully defined. On the other hand, carrying out this option would delay the X-30 program.

DEF-14 SLOW GROWTH IN THE STRATEGIC DEFENSE INITIATIVE

Savings from Admin. Request	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Budget Authority	700	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	360	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1989 Department of Defense budget amendment does not provide sufficient detail to compute annual savings beyond 1989 under this alternative.

On March 23, 1983, President Reagan called for the United States to render nuclear weapons "impotent and obsolete" by developing defenses that could destroy an enemy's nuclear weapons before they exploded on U.S. soil. The research and development (R&D) plan resulting from this mandate--known as the Strategic Defense Initiative (SDI)--has invested about $12 billion since 1984 to study applicable technologies and system concepts, ranging from space-based lasers and particle-beam weapons to more conventional antiballistic missiles. The Department of Defense has approved several projects, which will form the basis for an initial SDI deployment, to move from concept exploration to the more advanced phase of demonstration and validation of specific approaches. For 1989, the Administration has requested $4.6 billion for the SDI program.

The pace of SDI funding will determine how quickly SDI moves from a research to a development program. Some advocates argue that this pace should proceed as quickly as the fastest technological advances will allow. Others argue that SDI should not proceed beyond intensive research without greater understanding of how it would be integrated into the overall U.S. defense posture--including offensive forces, arms control, and allied responsibilities. For example, preserving the Anti-Ballistic Missile treaty is a widespread concern in the Congress. A third group argues that only a particular focus of SDI should proceed as fast as possible, such as tactical ballistic missile defense or defense of U.S. intercontinental ballistic missiles.

Meanwhile, there is a growing concern that SDI budgets will overwhelm other important R&D efforts. The Administration's plan calls for a steep rate of real growth in SDI funding: 23 percent from 1988 to 1989 compared with 1 percent real decline in the research, development, test, and evaluation (RDT&E) budget. Thus, the SDI will consume a greatly increasing share of Department of Defense research spending. In 1985, the first year of the SDI program, it represented about 4 percent of the RDT&E budget. In 1989, that share would rise to about 12 percent.

Concerns about technological balance and the pace of SDI growth could be partly addressed by slowing the rate of growth in spending (in real terms) during the next year. This option assumes that SDI funding grows in 1989 at only 4 percent in real terms, the same rate of growth experienced in 1988. Such a slowdown would save $700 million in budget authority in 1989. Remaining funding should allow evaluation of the feasibility of new SDI technologies. This slowdown would also allow more time to develop this large program efficiently and to debate fully the technical and arms control issues involved in these efforts. Under this alternative, however, the SDI would be deployed later than under the Administration's plan--a major drawback in the view of SDI supporters.

DEF-15 REDUCE FUNDING FOR MILITARY CONSTRUCTION PROJECTS

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Savings from Administration's Request						
Budget Authority	390	460	530	590	640	2,610
Outlays	70	220	350	450	510	1,600
Savings from CBO Baseline						
Budget Authority	340	350	370	380	400	1,840
Outlays	60	190	270	330	340	1,180

Military construction funding for the Department of Defense pays for a wide range of activities: combat-related construction, such as ammunition storage facilities and aircraft maintenance facilities; morale- and welfare-related construction, such as gymnasiums and child-care centers; and living accommodations, such as barracks and housing for unaccompanied personnel. These funds also pay for acquiring land for military use and for modifying existing facilities.

Military construction funding increased by an average of over 10 percent annually in real terms from 1980 through 1986. In 1987, however, the Congress reduced real budget authority for this purpose to 5 percent below the 1986 appropriated level, before providing a real increase of 3 percent in 1988. For 1989, the Department of Defense has asked for $5.7 billion in budget authority for military construction, or a real increase over the 1988 appropriated level of about 1 percent. If this request was restricted to the 1988 appropriated level and held constant in real terms in subsequent years, this option would save $390 million in budget authority in 1989 and $2.6 billion over the five-year period relative to the Administration's request. Savings relative to the CBO baseline would be $340 million in 1989 and a total of $1.8 billion through 1993.

Potentially adverse effects of continuing to limit the growth in military construction are difficult to assess because of the large number of projects in this area, each of which could be affected differently. Some projects would probably take longer to complete, while some planned military construction programs would probably be canceled or postponed indefinitely. Even some new projects that have received strong support from the services--such as military construction programs at Fort Drum, New York, to support one of the Army's new divisions, and the Navy's plan to establish new home ports for some of its fleet (see DEF-16)--might have to be reduced unless spending for other projects was lowered to offset their cost.

DEF-16 CANCEL THE NAVY'S PLANS FOR NEW HOME PORTS

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	110	n.a	n.a.	n.a.	n.a.	n.a.
Outlays	20	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1989 Department of Defense budget amendment does not provide sufficient detail to compute annual savings beyond 1989 under this alternative.

To accommodate the growing number of naval ships, the Navy intends to increase the number of home ports. Major new facilities are slated for Staten Island, New York; Everett, Washington; and Ingleside, Texas. New and modified facilities would also be constructed at San Francisco and Long Beach, California, and at seven ports on the Gulf of Mexico. The New York, California, and Texas facilities will each provide berths and supporting facilities for major elements of a Surface Action Group (SAG) centered around a reactivated battleship, while the Washington and Gulf ports will each support an aircraft carrier battle group.

The Navy contends that expanding the number of home ports will confer a variety of benefits. First, it will reduce the vulnerability of the fleet by dispersing it. In 1980, about 48 percent of the Navy's ships were in two home ports--San Diego, California, and Norfolk, Virginia. The Navy estimated that the increase in active ships from 479 in 1980 to a projected total of more than 600 would--without any increase in home ports--result in almost 100 additional ships being located in these two areas, raising the concentration to 55 percent. The port expansion program would reduce that percentage to about 40 percent.

The Navy also states that the program could enhance the integrity of battle groups by basing ships that will operate together in a common location, reducing time to respond to some military contingencies, and providing an expanded industrial repair base in the event of a war. The program might also benefit Navy Reserve forces by allowing reserve training activities to take place in more locations and permitting the deployment of Navy Reserve ships nearer to where their crews reside.

Public support for this program has also been significant. An unusual aspect of the program featured competition for new ports; communities bid for the rights to a new home port by raising local funds or providing land and improvements to offset some of the facility's cost. Nearly $150 million in state and local funds have been pledged to supplement the $799 million in federal construction funds the Navy estimates will be needed to begin operating the new ports.

Congressional concerns have focused on three issues: the costs of the program, its military benefits, and environmental and social issues. Some critics say that the Navy's estimates understate the costs of the program. The $799 million in construction funds pays for an austere program designed to achieve initial operating capability and does not include many projects considered desirable but not absolutely necessary. For example, the master plan for the site in Everett, Washington--developed by a Navy contractor--includes projects other than those needed for an austere program and carries a price tag of $442 million, compared with the Navy's plan for expenditures at Everett of only $272 million. Even if not approved now, many of the projects not included in the Navy's austere plan eventually may be found in the service's requests for construction at these facilities.

The home-port program would also add to costs of operation and maintenance (O&M). A 1986 analysis by the Navy suggested that locating the East Coast Surface Action Group at Staten Island instead of at an existing port would raise O&M costs by between $10 million and $12 million per year. These O&M cost differentials--reflecting only the austere facilities initially identified by the Navy--would widen if, in fact, total investment in facilities exceeds that contained in the Navy's austere plan.

Nor, according to critics, is it clear that the program offers substantial military benefits. Except in a nuclear war, the Soviet Union has limited ability to attack U.S. ports. In a nuclear war, having more home ports would not substantially reduce vulnerability.

This option would deny all funds for construction or improvement of these new home ports except in two cases--Staten Island, New York, and Everett, Washington--where significant construction is already under way. The Navy would therefore have to make fuller use of existing facilities throughout the country rather than build new facilities. Savings under this alternative would be $110 million in 1989. If funds the Congress appropriated in 1988 for the Gulf ports were to be reprogrammed to complete Staten Island and Everett, additional savings of at least $230 million could be realized in later years.

DEF-17 REDUCE FUNDING FOR OPERATION AND MAINTENANCE

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Savings from Administration's Request						
Budget Authority	1,510	2,140	3,140	3,960	4,720	15,460
Outlays	1,140	1,930	2,850	3,690	4,460	14,070
Savings from CBO Baseline						
Budget Authority	0	0	0	0	0	0
Outlays	0	0	0	0	0	0

About 28 percent of 1988 defense appropriations supports the operation and maintenance (O&M) of existing plant and equipment. Part of this account pays for civilian workers. The rest purchases goods and services for maintenance of existing equipment, training, fuel and spare parts, base operations, and many other things. Such spending is commonly referred to as "readiness" spending, since it contributes directly to the day-to-day capability of the military forces.

Since 1982, O&M budget authority has increased about 14 percent in real terms. Although some of this growth was needed to support an increase in forces for both the Navy and Air Force, much of it, according to the Department of Defense (DoD), was used to increase the readiness and training of existing forces. Current budget plans call for O&M budget authority to increase a total of about 8 percent in real terms during the next five years. Presumably this higher funding stems from the cost of operating new equipment and of placing current forces at an even higher state of combat readiness and effectiveness.

These increases in O&M could be appropriate if history is a guide. The total value of major defense weapons will increase during the next few years. Over the last 10 years, O&M has correlated reasonably closely with the total value of weapons. If this relationship continues, demands for O&M could increase even though current de-fense plans will probably lower the rate of growth in the value of weapons.

On the other hand, substantial increases in O&M would not be needed if the services limited their O&M spending per weapon in the future to what they spend today. Based on five-year plans for force structure and modernization submitted by DoD in January 1987, CBO estimated that planned changes would require an average real increase of less than 1 percent in O&M spending over the next five years, if spending per weapon remained unchanged. The Administration, however, has requested in the 1989 budget amendment annual real growth of about 1 percent, although it has reduced the force structure and slowed the modernization plans of a year ago. Thus, lower levels of O&M spending overall might allow DoD to maintain the current level of spending per weapon. Because DoD claims the forces are at a high level of readiness, it may be reason-able to assume that the current level of spending per weapon is adequate.

If improvements to date in force readiness were deemed sufficient, growth in real O&M funds could be slowed. In 1988, the Congress reduced the Administration's request in budget authority for O&M by about 6 percent, which resulted in a real decline of about 3 percent in budget authority over the 1987 level. Limiting the O&M funding to zero real growth over the next five years would save $1.5 billion in budget authority in 1989 and a total of $15.5 billion through 1993 relative to the Administration's request. Relative to the CBO baseline, however, this option would offer no savings in any of the next five years.

Although it would save money, this option might require reducing some operating tempos relative to the Administration's planned level, unless O&M efficiencies could be realized. CBO cannot specify in detail the effects of such a limit because of the large number of O&M projects, each of which could be affected differently.

DEF-18 RETIRE TWO AIRCRAFT CARRIERS EARLY

Savings from Admin. Request	1989	1990	1991	1992	1993	Cumulative Five-Year Savings
	Annual Savings (In millions of dollars)					
Savings in Total Federal Budget						
Budget Authority	400	900	900	1,000	1,000	4,200
Outlays	250	600	700	800	800	3,150
Savings in Defense Budget						
Budget Authority	400	900	900	1,000	1,000	4,200
Outlays	300	700	800	900	1,000	3,700

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

Increasing the number of deployable aircraft carriers from a level of 13 in 1980 to 15 has been a key part of the Reagan Administration's policy of building a 600-ship Navy. The Navy currently fields 14 deployable carriers and expects to activate the fifteenth carrier in 1990. This option retires two older carriers, the Coral Sea and the Midway, in 1989, thus reducing the total number of deployable carriers by two. To reflect the decrease in carrier forces, this option also reduces the number of active carrier air wings from 13 to 12. Savings under this alternative amount to $400 million in 1989 and a total of $4.2 billion through 1993.

The requirement for 15 aircraft carriers is driven in part by the controversial forward maritime strategy. The strategy posits that, during a conventional war with Warsaw Pact forces in Europe, aircraft carriers would attack forces around heavily defended areas near the Soviet Union's main naval bases at Murmansk on the Barents Sea and at Petropavlovsk on the Pacific Ocean. Such attacks might cause the Soviets to withhold forces that could otherwise attack allied shipping in the Atlantic and Pacific oceans. Critics argue, however, that even 15 carriers would not be able to bring about the military goals envisioned by the maritime strategy. Other approaches to ensure the protection of sea lines of communication, such as denying

Soviet submarines access to the Atlantic, might be more appropriate and may not require as many carrier battle groups.

Costs of sustaining a 15-carrier battle group Navy far into the future could also be high. In 1985, CBO estimated that the Navy would require between 3 percent and 5 percent real growth in its budget to sustain the 600-ship Navy. This growth, however, has not been realized and is even less likely for the near future. Thus, though the Navy maintains a goal of 600 ships, it will probably not be able to procure the numbers of aircraft and types of surface ships needed to make full use of 15 aircraft carriers.

The Navy counters that its goal of 15 carriers represents its minimum requirement. In support of this goal, the Navy states that the Joint Chiefs of Staff and the Commanders-in-Chief of the Unified Commands--those entrusted with establishing war-fighting requirements--recommend a force of more than 20 carriers to carry out existing defense commitments. Thus, 15 carriers may not be excessive based on U.S. defense commitments. The Navy also maintains that 15 carriers are required to support current operations in peacetime, since it now takes three carriers in the force to keep one carrier forward deployed.

DEF-19 CLOSE SELECTED MILITARY BASES AND FACILITIES

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
	Savings in Total Federal Budget					
Budget Authority	0	0	340	420	430	1,180
Outlays	0	0	330	410	430	1,170
	Savings in Defense Budget					
Budget Authority	0	0	380	480	490	1,350
Outlays	0	0	370	470	490	1,340

NOTE: Savings in the federal and Department of Defense budgets differ because of the treatment of social security and other retirement withholdings that are offset in the federal budget.

The military departments operate over 900 major military installations and facilities in the United States and its territories. It has often been suggested that savings in the Department of Defense (DoD) budget could be achieved by consolidating operations in fewer locations and shutting down unnecessary facilities. In 1983, the President's Private Sector Survey on Cost Control (commonly known as the Grace Commission) estimated potential savings from consolidating bases at $0.9 billion per year, but provided no details to validate this estimate. In 1985, the Secretary of Defense and the Chairman of the Senate Committee on Armed Services conducted a joint review which estimated that closing 22 facilities would save about $0.5 billion a year in operating costs.

Attempts to save money through base closures face several obstacles. Difficult political problems are involved in closing a base. Moreover, the need to move operating personnel and equipment to new locations generates one-time costs that offset near-term sav-ings. In the 1985 study, these one-time costs, which included construc-tion of new facilities to house the relocated activities, were estimated to total $2.5 billion, equal to five years of operating savings. Thus, at the time, base closures were judged an ineffective way of reducing the deficit in the near term.

Previous studies have suggested activities with the potential for closing or consolidating bases. Analyses by the General Accounting Office (GAO) suggest that up to 5,800 DoD civilian jobs might be cut by reorganizing the supply of spare parts and other items, closing some of the 30 supply depots, and consolidating depot maintenance activities (7 of the 22 installations on DoD's 1985 list of potential nominees were in this category). Other proposals stress consolidation of base support services, such as medical and recreational facilities, commissaries, and administrative centers. Duplicate facilities close to each other would be eliminated; members of the various military services would share each other's facilities. GAO believes this action could eliminate as many as 8,800 jobs.

This alternative does not designate specific bases that should be closed. Rather, based on GAO studies, it assumes a reduction of 15,000 workers in DoD's civilian work force over the next three years, to be achieved by consolidating and eliminating duplicate facilities. Total federal budget savings under this alternative would be $1.2 billion over the next five years. Savings in the first two years are assumed to be offset completely by costs associated with initial consolidation. Long-term savings may be greater, however, because savings in this option assume only personnel reductions and, for lack of data, do not include other reductions in nonpersonnel operating costs associated with fewer bases and facilities.

The major advantage of this alternative is the savings associated with more efficient operations. Efficiency should be improved in the long term because there would be fewer facilities to maintain and operate. Consolidating depot and warehouse operations should lower costs of distribution, allowing for a reduction in personnel with no real decrease in capability.

Offsetting costs, however, are a major disadvantage. No savings would be achieved in the first two years of transition under this alternative because of the one-time costs of moving personnel and closing facilities. In a constrained budget environment, near-term costs are a major consideration that limit the attractiveness of this option.

DEF-20 REDUCE ACTIVE-DUTY END STRENGTH TO 1982 LEVEL

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	260	900	1,310	1,360	1,420	5,260
Outlays	170	620	940	1,000	1,050	3,790
Savings in Defense Budget						
Budget Authority	280	940	1,370	1,420	1,480	5,490
Outlays	260	910	1,350	1,420	1,480	5,420

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

Since 1980, active-duty end strength (the total number of active-duty military personnel at the end of the fiscal year) has increased by almost 5 percent, from 2,040,000 in 1980 to 2,138,000 proposed for 1988. Much of this increase in personnel was used to meet the expansion in the Navy and the Air Force. For example, in 1980 the Navy had a total of 479 battle force ships, including 13 deployable aircraft carriers. In 1988, the number of battle force ships will reach 570, an increase of 21 percent, with 14 deployable aircraft carriers. Similarly, the Air Force increased the number of its tactical fighter wings from 34 in 1980 to almost 38 in 1988.

It is not clear that the Administration's national security policy requires this increase in forces. Rather than follow previous approaches in planning capabilities to fight one major war--or one major war plus a separate minor conflict--this Administration has been less specific about its strategy for conventional forces. Former Secretary of Defense Weinberger indicated, however, that the Administration's conventional strategy is not so different from that of previous Administrations.

Moreover, budgetary constraints have not allowed the Administration to achieve all of its original force goals. Although the Navy had expected to achieve a numerical goal of 600 ships by the end of fiscal year 1989, current plans indicate that only 580 ships will be available. Nor has the growth in the number of active-duty personnel for the Navy kept up with what would be needed to man these ships fully while maintaining what the Navy would consider a desirable rotation between sea and shore duty. The Air Force goal of 40 tactical fighter wings by 1986 was revised downward; current plans would reduce the number of tactical fighter wings to 35 by 1990. The Army increased its total number of active-force divisions from 16 to 18 by decreasing the size of previously existing divisions and transferring some support responsibilities from the active to the reserve forces. The Army plans to maintain this total number of divisions but will decrease the number of active-duty units--battalions and brigades--within some divisions.

Efforts to reduce the budget deficit could constrain future defense budgets even below today's levels. Overall spending reductions might lead to reductions in personnel in order to maintain at acceptable levels the spending for high-priority programs for research and procurement--such as the Advanced Technology Bomber, Advanced Tactical fighter, and the Strategic Defense Initiative--and to retain spending for day-to-day operations at about today's level. Indeed, a recent study by the Department of Defense inferred that this might be an acceptable strategy.

This alternative would reduce active-duty end strength by 40,000 below the 1988 level over the next two years, leaving it at about the level authorized in 1982. Immediate savings under this alternative in defense personnel accounts would be $260 million in budget authority in 1989 and $5.3 billion over the next five years, assuming the reductions are applied proportionally and at all pay grades. These savings reflect reduced costs for personnel and personnel support. Even when the reduction was fully carried out, however, the cuts would amount to about 0.5 percent of the total defense budget--far less than the roughly 2.0 percent reduction in personnel.

Achieving further cost savings would depend on how the reductions were accommodated. Reductions of this magnitude could require changes in the force structure. For example, the Navy would be hard pressed to man all of its ships and might have to retire many ships earlier than planned. The number of deployable aircraft carrier battle groups might fall to 13, the number that existed in 1982. The Air Force might have to reduce further the number of tactical fighter wings and retire some B-52s early. The Army could deactivate two divisions, returning to the 16 active divisions that existed before 1985. These reductions in force structure should eventually lead to substantial reductions in procurement costs as fewer weapons are needed. Such reductions might take several years, however, since much of the procurement planned in the next few years would be needed to modernize the remaining forces. Moreover, some of the personnel reductions under this option could be accomplished by reducing overhead rather than fighting units, which would not lead to procurement savings even in the long run.

Nevertheless, force changes of this magnitude would inevitably reduce defense capabilities. The number of ships actively deployed at any given time during peacetime would be reduced from current levels. In the event of a major war with the Soviet Union, there would be fewer tactical air and combat ground forces than there are today. No one can assess precisely how this would affect the outcome of a major war in Europe, but it would add risk. Force levels would still match those that existed in 1982, however, and by most measures offered by the Department of Defense, the quality of the forces today is higher than it was at that time. Thus, although defense capabilities under this option would be lower for some contingencies, they would exceed the 1982 levels.

In addition, the losses in capability caused by reductions in end strength would be mitigated somewhat by the productivity-enhancing effect of increased seniority in the services' enlisted forces. Average experience is increasing in all the military services. Evidence on trade-offs in the military between experience and productivity is limited, but available evidence suggests that increases in seniority could offset somewhat the loss of aggregate effectiveness resulting from this option (see DEF-21).

DEF-21 REDUCE ENLISTED END STRENGTH IN LIGHT OF PROJECTED GROWTH IN SENIORITY

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	100	240	310	490	670	1,820
Outlays	80	170	220	360	490	1,330
Savings in Defense Budget						
Budget Authority	110	250	320	510	700	1,900
Outlays	100	240	320	500	690	1,860

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The period since military conscription was ended in 1973 has been marked by a gradual shift toward greater seniority in the active enlisted forces. This shift will probably continue into the 1990s, with large increases in the number of senior career personnel both adding to personnel costs and improving the capabilities of the enlisted forces. Growth in seniority could add about $240 million to personnel costs in 1989 and a total of $2.0 billion over the five years from 1989 through 1993, relative to what costs would be if average experience did not increase. This total could rise to as much as $3.3 billion if the percentages of personnel in the higher pay grades are allowed to increase. Improvements in the average productivity of enlisted personnel stemming from greater seniority could exceed 1 percent by 1993.

Although increased seniority raises average personnel costs, it can contribute to deficit reduction if the greater productivity of more experienced personnel is balanced by reductions in enlisted end strengths (that is, the numbers of enlisted personnel employed at year's end). The Administration plans to cut end strength during 1988, but has not indicated that these cuts reflect adjustments for higher productivity. Further cuts should be possible without reducing the capabilities of the enlisted forces below the levels called for in the Administration's plan. Based on a conservative estimate of the extent to which productivity increases with experience in the military, additional reductions totaling roughly 35,000 enlisted personnel should be possible by 1993.

Savings to the federal government under this option would total \$100 million in 1989 and more than \$1.8 billion over the next five years. The defense budget would be reduced by \$1.9 billion over the five years, the difference being accounted for largely by the accrual charges for military retirement. In addition, the need for greater efficiency would force the services to examine more closely the productivity trade-offs among personnel at various levels of experience and to consider alternative uses of their senior personnel, who traditionally have been limited to supervisory roles.

But there are some risks. Evidence on the relationship between experience and productivity in the military is very limited, which raises questions about whether productivity increases would be sufficient to offset the proposed decline in numbers of personnel and avoid declines in overall force capability. In addition, the available productivity data are not entirely appropriate for application to an entire service, and the services' manpower systems may not be able to take full and prompt advantage of whatever productivity improvements come with greater average experience. The services' personnel plans also may already reflect some adjustments for greater seniority--that is, the services might argue that, without increased seniority, their strength requests would be larger.

This option would further decrease the ratio of first-term to career personnel in the enlisted force, which might be undesirable. Some critics of the volunteer military have seen the increased reliance on a "professional" military as a major defect because it reduces the role of "citizen soldiers" who serve only for a short period.

DEF-22 LIMIT MILITARY PAY RAISE

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	1,140	1,580	1,650	1,720	1,790	7,870
Outlays	790	1,130	1,200	1,260	1,320	5,700
Savings in Defense Budget						
Budget Authority	1,190	1,640	1,720	1,790	1,870	8,210
Outlays	1,130	1,620	1,710	1,790	1,860	8,120

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

Under current law, military personnel will receive a pay raise in October 1988. The Administration proposes instead that the raise be delayed until January 1, 1989, and amount to 4.3 percent. Limiting the January raise to 2 percent, coupled with increased spending on first-term reenlistment bonuses as described below, would satisfy many of the purposes of the larger proposed increase at considerable savings. Defense budget authority would be reduced by $1.2 billion from the Administration's request in 1989, and by $8.2 billion over the next five years (assuming that annual raises after 1989 keep pace with those in the private sector, without any adjustment to recoup the 1988 loss).

The 2 percent raise would represent a compromise between the dictates of pay comparability and pay competitiveness relative to that of the private sector. The Administration's request would maintain current levels of comparability. Short-run deviations from comparability are justified, however, when recruiting and retention conditions are particularly good or bad. Recent retention and recruiting successes--indicated by first- and second-term reenlistment rates near historical highs, and by continued high percentages of new personnel with high aptitude and high school diplomas--suggest that a more modest pay increase might give the services a sufficiently strong competitive position to meet their needs. No increase at all might erode the confidence of service personnel in the Congress's long-term commitment to comparability.

Reduced first-term reenlistment rates resulting from the smaller pay raise could cause a problem. Although the rates would remain high by historical standards, the decrease would eventually reduce the size of the career force. An increase of about $180 million in spending on first-term reenlistment bonuses would offset the effect of the less-than-comparable pay raise on the number of first-term personnel who reenlist and improve the services' abilities to correct imbalances in strength across military occupational specialties. This added spending is not reflected in the above figures.

Although solving needs for numbers of personnel, added bonuses could create other problems. Selectively increasing the pay of service members beginning their second enlistment tours would contribute to "pay compression"--that is, reduced pay advantages of senior over junior personnel. Although senior personnel who were unhappy about this compression might not leave in large numbers, they could lose motivation and become less productive. In addition, the extra personnel retained by higher first-term bonuses might leave upon completing their additional service obligations. Whether this effect is undesirable would depend on the services' future requirements for senior career personnel.

DEF-23 INCREASE CHARGES FOR MILITARY HOSPITAL CARE

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	120	120	120	120	120	600
Outlays	90	120	120	120	120	570

Military hospitals treat more than half a million inpatients each year who are retired military personnel or dependents of retired or active-duty personnel. Most of these patients pay small charges. Dependents pay $7.85 per day (or $25 for their entire stay, whichever is higher), retired officers pay $3.85 per day, and retired enlisted personnel pay nothing. The Department of Defense (DoD) could save about $120 million a year in budget authority by having nonactive-duty inpatients pay a larger share of the costs of their care.

On average, it costs the DoD $466 a day to treat an inpatient in a military hospital. This option calls on beneficiaries to pay a larger share of the costs of one day's hospital stay. On the first day of hospitalization, inpatients from enlisted families would pay a deductible of $150, and inpatients from officers' families would pay $250. Dependents of active-duty personnel who use the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) for care in a civilian hospital would also pay a $150 or $250 deductible, because their charges under CHAMPUS are supposed to equal their charges in a military hospital. Retirees and their dependents who use CHAMPUS would continue to pay the present rate of about $175 a day.

These higher charges would bring the military's health care system more in line with medical plans offered to civilian employees by the federal government. Most fee-for-service plans in the Federal Employees Health Benefits program charge deductibles of between $175 and $275, in addition to copayments of between 10 percent and 25 percent. Medicare beneficiaries must pay a deductible of $540 to cover the average cost of one day's hospital stay.

Higher deductibles might also discourage some unnecessary hospital admissions. On a per capita basis, dependents of active-duty personnel enter hospitals more often than other civilians, possibly a result of relatively low costs. If higher deductibles reduce hospital admissions, military hospitals could free scarce resources for other medical uses (such as improvements in delivering primary care), or the Defense Department could realize additional budgetary savings.

Increasing hospital charges, however, might lower the morale and retention of active-duty personnel. Free or nearly free medical care is an important, long-standing benefit that military families value highly. Eroding that benefit might make some career personnel less willing to stay in service. Nonetheless, the effects might be small because only about one active-duty family out of five uses a hospital in any year. Moreover, recently legislated limits on out-of-pocket medical expenses would help protect families against undue losses.

DEF-24 ENACT DoD'S PROPOSED CHANGES IN THE NEW GI BILL

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority a/						
(Current baseline)	-130	-80	-20	30	60	-140
(Accrual baseline)	290	290	310	330	360	1,580
Outlays	-20	-50	-50	-10	0	-130 b/

a. To realize near-term savings from this option, all new GI Bill benefits would have to be funded on an accrual-accounting basis. Accrual accounting would require the Veterans Administration to reflect future obligations to new GI Bill beneficiaries in current budgets. Under current law, however, these obligations are funded on a year-by-year appropriation basis and do not appear in current budgets. As a result, compared with a current baseline without accrual accounting, this option increases budget authority in fiscal years 1989, 1990, and 1991. To better reflect the option's long-run effects, savings are also shown relative to a baseline that assumes accrual accounting.

b. Regardless of baseline, a decrease in total participants' contributions under this option causes total federal outlays to increase over the five-year period. Longer-term savings in payments to students, however, will greatly outweigh this relatively small near-term increase.

On June 1, 1987, President Reagan signed into law a permanent peacetime GI Bill, offering new recruits the opportunity to earn money for college in return for military service. The new GI Bill offers most new service members with a high school diploma a basic educational benefit of $10,800 in return for forgoing $1,200 in first-year pay (recruits signing a two-year contract earn a smaller basic benefit of $9,000). The military services also may offer supplemental benefits to qualified men and women enlisting, although the Army is the only service that has consistently chosen to do so. About 60 percent of all new recruits have elected to participate in the plan, attesting to its popularity.

If participants in the new GI Bill eventually use a high percentage of their benefits, however, the program could prove to be quite costly. Under current law, basic benefits are funded by the Veterans Administration (VA) on a year-by-year appropriation basis. Because most GI Bill beneficiaries do not attend school immediately after entering service, obligations owed to them do not appear in current budgets, but will have to be paid in the future. CBO projects that these costs could rise to $312 million a year by 1993.

This alternative, first presented by the Administration in its budget for 1988, but not adopted by the Congress, seeks to reduce future costs to the government and promote longer terms of service among recruits by reducing basic GI Bill benefits for members enlisting for fewer than six years. The basic benefits under current law and under this option are as follows:

Length of Contract (In years)	Basic Benefit Amount Under Current Law (In dollars)	Basic Benefit Amount Under Alternative (In dollars)
Two	9,000	2,400
Three	10,800	4,800
Four	10,800	7,200
Six	10,800	10,800

To reflect future training costs in current budgets, this alternative also proposes, as did the Administration, that funding for the basic benefit be changed--from the current year-by-year appropriation basis to an accrual-accounting basis, similar to the Defense Department's funding of reserve and supplemental educational benefits. Under accrual accounting, the VA would be required to set aside sufficient money in a trust fund each year to cover future benefit payments to all personnel entering service in that year. Thus, savings from reductions in GI Bill benefits would appear when the obligation is incurred, rather than when the benefits are paid in the future.

Under this proposal, savings relative to an accrual-accounting baseline would be $290 million in 1989 and would total $1.6 billion over the five-year period. Additional savings might arise from a decrease in training and recruiting costs if the change in benefits promotes longer contracts. The proposed reductions in benefits, however, would make the program less attractive, reducing participation to 45 percent, as estimated by CBO.

A disadvantage of this option is that it would reduce the effectiveness of the new GI Bill as a recruiting incentive for youths with above-average aptitude and a high school diploma. According to CBO estimates, the percentage of these recruits would fall to about 56 percent in 1988 (from about 60 percent in 1987) in the military services overall, but to about 52 percent (from about 58 percent in 1987) in the Army. The Army has relied more heavily on educational benefits as a recruiting tool than the other services. If the services elected to enlist more recruits lacking a high-school diploma (who are less likely than graduate recruits to complete their initial tours) rather than relaxing aptitude standards, training and recruiting costs might rise. This effect might reduce the savings from this option.

DEF-25 RESTRICT RESERVE RETIREMENT BENEFITS

Savings from Admin. Request	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	70	140	200	260	330	1,000
Outlays	0	0	0	0	0	0
Savings in Defense Budget						
Budget Authority	70	140	200	260	330	1,000
Outlays	70	140	200	260	330	1,000

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

In 1986, after decades of discussion, the Congress modified the retirement system for active-duty military personnel. Active-duty personnel who complete 20 or more years of service are eligible to transfer to the retirement rolls as members of the Retired Reserve; they remain legally subject to recall during national emergency and receive retirement benefits, called retired pay, based on length of service and average highest three years' pay. These benefits were restructured to encourage longer military careers, to provide adequate retired pay during old age, and to generate savings for the taxpayer. Changes in the retirement system for reservists, however, were deferred pending the report of the Sixth Quadrennial Review of Military Compensation scheduled for release in April 1988.

Unlike retired pay for active-duty personnel, which was first provided for veterans of the Civil War era, reserve retirement is a relatively new program dating only from 1948. Reservists are entitled to receive retired pay after 20 years of creditable service, of which at least the last eight must be served in a reserve component. Unlike active-duty personnel, who can receive retired pay immediately upon retirement, reservists must wait until age 60. Reservists' retired pay is calculated in a manner similar to that for active-duty retirees, on the basis of length of service and average highest three years' pay. The United States is the only country that offers retirement benefits to reservists.

These benefits, however, are provided at a considerable cost. In 1986, reservists received $1.2 billion in retired pay. For fiscal year 1988, the Department of Defense Actuary calculated the accrual charge for reserve retired pay as 26.1 percent of reservists' total basic pay, or $929 million. (The accrual charge represents dollars set aside now to pay the future retirement costs of today's reserves.)

To reduce these costs, this option would terminate the reserve retirement program for those entering the reserve components after the end of fiscal year 1988. Savings under this alternative would be $70 million in 1989 and would total $1 billion through 1993. Out of considerations of equity, CBO's estimates of the savings from termination assume full grandfathering of all current reservists under the present reserve retirement system. No new reservists, however, including those who enter the reserves from active duty, would be eligible to accumulate benefits. Under this approach, savings in reserve retirement accrual charges would grow steadily, as shown in the above table. Savings in total federal outlays, however, would not be realized for many years.

Terminating the reserve retirement system would chiefly affect the retention decisions of reserve officers rather than enlisted personnel. Fully 86 percent of the 1986 benefits--over $1 billion--were paid to retired officers, who account for 76 percent of the population of reserve retirees. Enlisted retirees received only $178 million in benefits, or 14 percent of the total, although enlisted personnel account for 86 percent of the reserve forces. In contrast, retired active-duty officers make up only 26 percent of the active-duty retiree population and received only 44 percent of the total benefits paid to that group.

Given this distribution of benefits, the reserve retirement program may contribute to high retention among officers but not among enlisted personnel. In general, however, the reserve components do not suffer from shortages of officers, and especially not senior officers. Personnel shortages have been concentrated in junior enlisted ranks, typically in pay grades E-3 and E-4, and thus are not alleviated to any appreciable extent by reserve retired pay. Accordingly, termination of the reserve retirement program could be expected to generate savings without major adverse effects on the reserve components' ability to meet their personnel objectives.

Terminating the reserve retirement system, however, might entail some adverse effects. Reserve retirement benefits appear to achieve their stated purpose of holding reservists for longer careers, since a larger fraction of reservists remain for more than 20 years of service than do active-duty personnel. In addition, the reserve retirement program serves to make the reservists' compensation package more comparable with that of active-duty personnel. This comparability may help to maintain a substantial reserve, which the Congress has strongly supported in the past.

DEF-26 RESUME CONSCRIPTION FOR THE ACTIVE-DUTY ARMED FORCES

Savings from Admin. Request	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Savings in Total Federal Budget						
Budget Authority	1,700	1,790	1,000	1,350	1,320	7,160
Outlays	2,730	2,990	2,490	2,620	2,590	13,420
Savings in Defense Budget						
Budget Authority	3,230	3,340	2,830	3,140	3,240	15,780
Outlays	3,070	3,340	2,860	3,120	3,240	15,630

NOTE: Savings in the federal and Department of Defense budgets differ because of accrual accounting applied to the retirement costs of military personnel and to the GI Bill, and because of other pay costs that are offset in the federal budget.

Since 1973, the military services have manned their enlisted forces solely with volunteers. Returning to conscription--using a national lottery draft as in the early seventies--could save about $1.7 billion in 1989 (roughly 2 percent of the funds requested in 1989 for military personnel) if the Congress (1) repeals the special pay raises granted new recruits shortly before the United States moved to a volunteer force, thus reducing by half the value of recruits' pay, (2) ends enlistment bonuses and other special inducements, (3) cuts the budget for recruiting and advertising in half, to its draft-era size, and (4) funds, on an accrual basis, an enhanced program of education benefits similar to the draft-era GI Bill. Annual savings after 1990 would be lower than $1.7 billion, even with inflation, because of increased turnover in the enlisted force; substituting two-year conscripts for longer-term volunteers would increase recruiting requirements and so the costs of moving, processing, and training personnel. Resuming conscription would reduce the five-year costs of manning the active-duty force by about $7.2 billion. If the Congress does not restore a draft-era GI Bill, and only eliminates the mandatory contribution under the present GI Bill (discussed in DEF-24), annual savings would be about $1.7 billion higher.

In addition to reducing personnel costs, resuming conscription would eliminate problems that some critics believe exist in the current volunteer force. If no exemptions to the draft were allowed, the draftees brought in--and, to a lesser extent, any draft-induced volunteers--would be a representative cross section of American youth. Concerns about a "mercenary" military would largely disappear, and "professional" soldiers would play a smaller role as the career enlisted forces shrank in size (see below). Finally, the reserve components could grow, although much of the increase might take place in the Individual Ready Reserve, whose members do not train.

On the negative side, without an increase in the size of the armed forces, fewer personnel would be available to serve in tactical units; the quality of recruits would decline from the high levels enjoyed under an all-volunteer force; and the career forces (those with five or more years of active-duty service) would shrink. The Army would experience the biggest changes, because it would have to depend on conscripts for more than half of its recruits.

Effective Forces. Conscription would reduce the number of "effective" personnel--people serving in the tactical and support units that directly provide defense capability--unless end strengths rose above today's levels. With higher turnover of personnel, there would be more recruits, particularly in the Army, each spending proportionally more time in training or moving between assignments. To support this expanded training base, the Army would have to divert several thousand trained soldiers from operational units. Thus, an Army with 660,000 enlistees would provide less effective strength under conscription than under current policy. The estimates above assume that the Army will offset this effect by adding roughly 28,000 soldiers to its enlisted end strength, an increase of about 4 percent.

Quality of Recruits. In recent years, the services have recruited record numbers of highly qualified recruits. Although high school graduates make up about 75 percent of the youth population, in 1987 fully nine active-duty recruits out of ten had high school diplomas. Moreover, only about one recruit out of twenty was well below average in aptitude (Category IV of the Armed Forces Qualification Test). Despite coming changes in demographic and economic conditions, an all-volunteer force should continue to attract high-quality enlistees over the next few years.

Under this option's version of conscription, with its regimen of lower pay and lean recruiting resources, fewer young men and women would volunteer to serve on active duty. Remaining needs for recruits would have to be met with a cross section of men selected by lottery, thus leading to fewer high school graduates and more low-aptitude soldiers in the military. Indeed, the proportion of Army recruits in Category IV would rise to one out of five. (These results assume that the services will accept volunteers who meet their current enlistment standards before resorting to conscripts.) Since low-aptitude soldiers perform 10 percent to 20 percent worse than their higher-aptitude peers, resuming conscription would lead to a less capable first-term force. Moreover, because relatively few high-aptitude conscripts would make the Army a career, the quality of the Army's more senior personnel would suffer.

Experience. A steady flow of conscripts would also erode the Army's recent gains in numbers of career personnel. In 1971, for example, the Army's enlisted force of 972,000 included about 250,000 personnel who had five or more years of active-duty service. Today a much smaller enlisted force of 660,000 supports roughly 310,000 career personnel. Under this option, the Army could expect to lose about 10,000 personnel from its career force by 1993 (another 20,000 by 2000). Such losses could exact a toll in the average productivity of enlisted personnel, since efficiency tends to rise with experience. Indeed, the projected reduction in the career force might lower overall productivity by about 3 percent, despite the 4 percent rise in end strength. (See DEF-21, which substitutes experience for end strength.)

In addition to affecting military capability, conscription raises a deeper social issue. "Who serves when not all serve" is the dilemma facing designers of forces manned either by conscripts or volunteers. The volunteer system lets people decide for themselves; conscription makes this selection by law. The values of individual freedom and economic efficiency are pitted against the social advantages of having "citizen soldiers" drawn from what might be a broader cross section of society.

CHAPTER IV

ENTITLEMENTS

Entitlement programs provide benefits to all people or jurisdictions who are eligible to receive aid and who choose to participate. The level of spending in entitlement programs is largely determined, not by the annual appropriations process, but rather by the program rules that govern eligibility, extent of participation, benefit levels, and cost of providing noncash benefits. But a variety of other factors that are beyond the control of the Congress--including demographic shifts, changes in providers' practices, and rates of inflation--also cause outlays for entitlements to rise or fall. Spending is, therefore, only partly under the direct control of the Congress.

In recent years, the Congress has cut spending for many of the entitlement programs, and this chapter includes 26 additional options for further reductions. These options would either lower outlays for entitlements and other mandatory spending, or increase the revenues earmarked to pay for them. For example, ENT-02 through ENT-13 deal with health care programs, while ENT-21 through ENT-25 discuss alternatives for reducing net federal outlays for Social Security and other retirement and disability programs. Other options deal with programs such as Aid to Families with Dependent Children and Guaranteed Student Loans.

Several of the options are substitutes for one another. Also, in some instances, the individual summaries describe more than one specific policy alternative. In general, the savings from the separate options--or from the variations within a single option--cannot be added together to arrive at a total.

All estimates of outlay savings and revenue gains from these options are calculated relative to CBO's baseline projections. The baseline projections are based on CBO's short-run economic forecast and longer-run projections as described in its recent report, *The Economic and Budget Outlook: Fiscal Years 1989-1993*. Baseline spending projections for entitlements and other mandatory spending programs reflect changes forecasted in several factors such as caseloads and the average federal cost per beneficiary. The latter may change over time--for example, because of cost-of-living adjustments in benefit payments or increases in either the price of medical services or the intensity of their use.

ENT-01 REDUCE SUBSIDIES FOR GUARANTEED STUDENT LOANS

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Require Students to Pay In-School Interest						
Budget Authority	-50	80	260	410	500	1,200
Outlays	-35	25	190	350	470	1,000
Raise Students' Interest Rates After Leaving School						
Budget Authority	--	15	50	95	140	300
Outlays	--	10	40	85	130	265
Reduce Lenders' Subsidies by One-Half of a Percentage Point						
Budget Authority	15	45	65	70	75	270
Outlays	10	35	60	65	70	240
Reduce Default Costs by Eliminating Borrowing for Students at Schools with High Default Rates						
Budget Authority	10	280	540	590	560	1,980
Outlays	10	260	540	590	560	1,960
Reduce Federal Default Costs by Restructuring Federal Reinsurance of Guarantee Agencies						
Budget Authority	190	240	240	240	240	1,150
Outlays	120	240	240	240	240	1,080

NOTE: The savings that would result from carrying out all five options jointly would not equal the sum of the separate estimates because of interactions among the options.

In the Guaranteed Student Loan (GSL) program, the federal government guarantees loans for postsecondary students and pays the interest while students are enrolled in school, providing lenders with a rate of return that varies with market interest rates. Because students do not begin repayments until after they leave school, and because they repay loans at fixed interest rates that are generally below market rates, they receive a substantial subsidy from the federal government.

In fiscal year 1987, in-school interest payments (net of a 5 percent student origination fee) accounted for about 40 percent of the cost of the GSL program; special allowance payments to lenders accounted for 20 percent; default payments net of collections equaled about 30 percent; and other costs equaled 10 percent. In recent years, in-school interest payments have remained relatively stable; special allowance payments have fluctuated as interest rates changed; and default costs have grown substantially with the sharp increase in the number of borrowers entering the repayment periods on their loans.

Require Students to Pay In-School Interest or Raise Students' Interest Rates After Leaving School. Federal subsidies could be reduced by requiring students to repay larger amounts than they do under current law. Charging students interest on their loans while they are in school but deferring actual payments until they leave school would reduce federal outlays by $1 billion between 1989 and 1993, if the 5 percent student origination fee were eliminated at the same time. Alternatively, raising students' interest rates after they leave school to the full interest amount the government now pays to lenders, but continuing the in-school interest subsidy, would reduce federal spending by $265 million during the 1989-1993 period and by more in future years. These estimates assume that only new borrowers would be affected.

The advantage of these measures is that they would not cause cash-flow problems for students while they are in school because students would be allowed to defer interest payments during that period. Thus, with the added costs generally occuring after graduation--when students would be more likely to be able to afford them--most students would still be able to continue their education. In addition, educational institutions might increase their own aid to offset some of the reductions in federal subsidies.

On the other hand, the larger repayment burdens resulting from these changes might cause some students not to attend school or to choose lower-priced institutions. In addition, some lenders might drop out of the program because of somewhat increased servicing costs and more complex interest calculations, which would make it more difficult for some students to obtain loans.

Reduce Lenders' Subsidies. Currently, for new loans, the federal government guarantees lenders a rate of return equal to 3.25 percentage points above the bond equivalent rate for 91-day Treasury bills. Although lowering this interest supplement while students are in school would reduce lenders' subsidies, it would do so during a period when their servicing costs are lowest. Each reduction of one-half of one percentage point in the yield on new loans while students are still in school would lower federal spending by a total of $240 million during the next five years.

Because current federal payments while borrowers are in school probably are higher than lenders' costs during that period, reducing these payments would not be likely to limit the availability of loans for most students. Moreover, reducing lenders' subsidies would lower federal expenditures without increasing students' costs. On the other hand, if this option made some loans unprofitable, lenders would stop providing these loans, making loans more difficult for some students to obtain.

Reduce Default Costs by Eliminating Borrowing for Students at Schools with High Default Rates. Eliminating eligibility for GSLs for students attending postsecondary institutions with high default rates could reduce federal outlays by nearly $2 billion during the 1989-1993 period. Although this proposal aims to reduce default costs, not borrowing, it would eliminate loans for some students, thereby lowering GSL interest subsidies, as well as default costs. This estimate assumes that restricting eligibility would lower GSL borrowing by 20 percent.

This approach would provide an incentive for institutions to take an active role in preventing defaults by their former students. In addition, if high default rates indicate that students are not getting a high-quality education--as supporters of this change contend--then this option could encourage students to attend better institutions or could encourage institutions to improve their programs.

On the other hand, preventing students at particular institutions from obtaining loans would penalize all students there, including those who would have repaid their loans. Furthermore, this approach places some of the responsibility for preventing defaults on educational institutions, which are not involved in providing GSLs to students or in collecting repayments. Finally, if low-income borrowers default more than other students and if they tend to be concentrated at particular schools, they would be adversely affected more frequently than other students, which could discourage them from attending postsecondary institutions at all.

Reduce Federal Default Costs by Restructuring Federal Reinsurance of GSL Guarantee Agencies. The federal government reinsures guarantee agencies on a sliding scale between 80 percent and 100 percent, with most guarantee agencies receiving close to 100 percent reinsurance. These agencies also collect from borrowers insurance premiums that are intended to cover default costs. Guarantee agencies use these premiums, as well as other funding sources, to operate programs and pay initial default costs. Providing 100 percent federal reinsurance to all guarantee agencies and requiring states to turn over to the federal government the borrowers' insurance premiums would reduce federal outlays over the next five years by just over $1 billion. Under this option, guarantee agencies would pay students' insurance premiums to the federal government, which is the entity that pays most GSL default costs.

The advantage of this approach is that it would link default insurance premiums with default liability in the federal government, while requiring states to support their student loan operations out of other funds. Most guarantee agencies seem to have enough funds to continue activities under this option. Some agencies might drop out of the GSL program, however, if they could no longer cover their operating costs, or they might restrict borrowing by high-risk students. Moreover, this option would reduce somewhat the incentive for guarantee agencies to work actively to prevent defaults, although the current incentive is relatively small because most states receive virtually 100 percent reinsurance.

ENT-02 ELIMINATE FEDERAL MATCHING PAYMENTS FOR MEDICAID RECIPIENTS ELIGIBLE ONLY BECAUSE THEY RECEIVE STATE SSI SUPPLEMENTS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Outlays	120	130	150	160	180	730

Some states provide Medicaid benefits, currently subject to federal matching payments, to a special group of elderly people who have incomes too high to qualify for federal Supplemental Security Income (SSI) payments, but who receive supplementary cash benefits from the state. Although the federal government does not match the states' cash payments to this special SSI group, it provides Medicaid matching funds for their medical expenses.

Eliminating federal Medicaid payments for members of this group would save $730 million over the five-year period from 1989 through 1993. Almost half of them live in California, a state with well above average per capita income and a relatively generous Medicaid program. Morover, this group has higher incomes overall than most Medicaid beneficiaries. (By definition, all elderly people who are ineligible for cash payments have incomes higher than the federal guarantee of $6,384 for a couple and $4,248 for an individual in 1988.)

On the other hand, an integral part of Medicaid's design is to allow states some flexibility in determining eligible groups. Moreover, this affected group is not much different from another one just added to Medicaid (as a state option) by the Congress--namely, elderly people with incomes above the federal SSI guarantee but below 100 percent of the poverty level. In addition, because almost half of the group lives in one state, this option would have an impact mostly on a single geographic area.

ENT-03 ELIMINATE FEDERAL MATCHING IN MEDICAID FOR MEDICARE'S PREMIUMS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Outlays	470	490	510	530	550	2,540

States are allowed to purchase or "buy-in" Supplementary Medical Insurance (SMI) for their Medicaid beneficiaries who are also eligible for Medicare. To do so, the state pays the same SMI premium as the beneficiary would have paid--an amount equal to about 25 percent of average benefits. Thus, states save roughly 75 percent of what would otherwise be costs for their Medicaid programs. Moreover, because the states' contributions toward premiums are matched by federal funds, states save an even higher proportion of the costs of medical care for these Medicaid beneficiaries. If state spending for SMI premiums were not matched with federal funds, about $2.5 billion would be saved over the five years from 1989 through 1993.

Nearly all states currently choose to pay the SMI premiums for their Medicaid beneficiaries who are also eligible for Medicare--about 88 percent of all aged and disabled Medicaid recipients. Even without federal matching funds, states would almost certainly continue to enroll those eligible for both Medicare and Medicaid. Otherwise, states would have to pay their share (net of federal Medicaid matching) of all the costs for the health care of these beneficiaries.

This option would reduce a substantial subsidy to states. That subsidy now effectively transfers a much higher proportion of one group's medical costs from the states to the federal government than is typical for Medicaid beneficiaries. On the other hand, if some states behaved differently from what is expected, some of the federal savings would come from those elderly and disabled who chose to enroll in the Medicare program at their own expense. Those who did not enroll in Medicare might face restricted access for physician and other ambulatory services.

ENT-04 REDUCE MEDICARE'S PAYMENTS FOR THE INDIRECT COSTS OF PATIENT CARE RELATED TO HOSPITALS' TEACHING PROGRAMS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Outlays	200	220	240	260	280	1,200

The Social Security Amendments of 1983 established the current prospective payment system (PPS) under which Medicare reimburses hospitals for inpatient services provided to beneficiaries. Payment rates are set in advance for each of 473 diagnostic categories known as diagnosis-related groups (DRGs). By the end of fiscal year 1988, payments to hospitals generally will be based on national rates, calculated separately for urban and rural areas.

Higher rates are paid to hospitals with teaching programs to cover their additional costs of Medicare patient care. The federal portion of payments to these hospitals is raised by approximately 8.1 percent (7.7 percent beginning October 1988) for each 0.1 percentage point of the hospital's ratio of full-time equivalent interns and residents to its number of beds. This adjustment was calculated both to compensate hospitals for their indirect teaching costs--such as the greater number of tests and procedures thought to be prescribed by interns and residents--and to cover higher costs caused by a variety of factors that are not otherwise accounted for in setting the PPS rates. These factors include severity of illness within diagnosis-related groups (DRGs), location in inner cities, and a more costly mix of staffing and facilities--all of which are associated with large teaching programs. If payments for the costs of treating a "disproportionate share" of low-income patients (a characteristic also associated with teaching programs) had also been included in the indirect teaching adjustment, it would have been 8.7 percent (8.3 percent beginning October 1988). The difference of 0.6 percentage points, which is not paid as part of the indirect adjustment, is used to finance part of the payments that are now made under a separate adjustment to hospitals for the costs of treating a disproportionate share of low-income patients.

Estimates of the indirect teaching adjustment based on the cost data from the 1984-1985 period suggest that the teaching adjustment could be lowered from 7.7 percent to 6.8 percent (from 8.3 percent to 7.4 percent if payments for the costs of treating a disproportionate share of low-income patients are included). If the teaching adjustment was lowered by this amount, outlays would fall by $1.2 billion over the 1989-1993 period.

This option would better align payments with the actual costs incurred by teaching institutions, which fell substantially in real terms between 1981 and 1984. On the other hand, it would considerably reduce payments to teaching hospitals, thereby potentially lowering the access to and quality of care for some benefi-ciaries.

Even if it were agreed that the indirect teaching adjustment should be lowered, the reductions in Medicare's payments could be either returned to hospitals in general by increasing payment rates, or removed from the PPS system as budget savings. The former approach is consistent with the original financing of the indirect teaching adjustment, which lowered payment rates for all hospitals rather than increasing outlays, but would do nothing to lower the federal budgetary deficit.

ENT-05 REDUCE REIMBURSEMENTS FOR CAPITAL EXPENDITURES UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Move Immediately to a Prospective Reimbursement System						
Outlays	170	300	420	560	730	2,180
Move Immediately to a Prospective Reimbursement System and Redefine Capital Expenses						
Outlays	260	420	550	710	900	2,850
Move Slowly to a Prospective Reimbursement System and Redefine Capital Expenses						
Outlays	10	80	220	430	720	1,470

Although the Social Security Amendments of 1983 set up a prospective payment system (PPS) to reimburse hospitals for operating costs associated with treating Medicare beneficiaries in various diagnosis-related groups (DRGs), they did not change the retrospective, cost-based method of reimbursing capital-related expenses such as interest, rent, and depreciation. Under the Reconciliation Act of 1987, cost-based reimbursements will be reduced by 12 percent effective January 1988, and 15 percent in fiscal year 1989. After the 12 percent reduction, reimbursements for capital expenses account for 9 percent of Medicare payments to hospitals, roughly $4.3 billion in fiscal year 1988. For fiscal year 1990 and beyond, cost-based reimbursement for capital will account for more than 10 percent of Medicare payments if no changes are made in current law.

All three of the approaches discussed here would lead to prospective payment for capital-related expenses. The first two would do so immediately, while the third would partially retain cost-based reimbursement during a five-year transition to a fully prospective system. In addition, two of the approaches would redefine the capital expenses that would be eligible for reimbursement under the prospective system. Under all three approaches, the payments for 1989 would be reduced by 15 percent to reflect the cut enacted in 1987.

Move Immediately to a Prospective Reimbursement System. The current cost-based method of reimbursement for capital-related expenses could be replaced immediately by a prospective system under which capital expenses would be reimbursed by increasing the DRG rates to reflect capital costs. If payments for capital were set to their level in 1988 on a per-case basis, Medicare outlays would be reduced by $2.2 billion during the 1989-1993 period. These savings would accrue because the DRG payments are projected to increase more slowly than actual capital costs.

Reimbursing capital expenses by increasing the current DRG rates would have several advantages. First, hospitals would have incentives to reduce their capital costs as well as operating costs; for example, under the current system, all interest costs are reimbursed, whereas the prospective system would encourage hospitals to delay projects when interest rates were high. In addition, this approach would avoid the current incentive to substitute capital for labor--the incentive that comes from combining prospective reimbursement for operating costs with cost reimbursement for capital expenses--even when that substitution would raise the hospital's total costs. Finally, prospective payments by Medicare would make federal outlays more predictable and controllable--for example, they could be controlled even if a hospital building boom occurred in the coming years.

The major drawback to this approach is that the capital expenditures of individual hospitals tend to be large and to occur infrequently. As a result, most hospitals have capital expenses that are much higher than average in some years and much lower in other years. In other words, an add-on based on the average level of capital costs per case in a base year would generally not match any particular hospital's current expenses.

In order to avoid large windfall gains or losses for some hospitals, a transition period could be established during which part of the prospective payment would be based on the increase or add-on described above, and part would be based on the particular hospital's capital costs per case in the base year. This modification--which is similar to the transition method used under the PPS system for operating costs--would still move to a prospective system immediately and would not affect the total savings. The distribution of payments among hospitals during the transition period would differ, however. Hospitals that have recently undertaken large capital obligations would gain, relative to using only a national add-on, while hospitals that currently have below-average capital expenses but need to modernize in the near future would lose.

Move Immediately to a Prospective Reimbursement System and Redefine Capital Expenses. In addition to paying for capital prospectively, as in the previous option, the definition of capital expenses used to calculate the add-on could be changed to reflect interest on funded depreciation. The Medicare program currently reduces interest expenses for interest earnings, except that interest earnings on funded depreciation--that is, on savings from past depreciation allowances--are exempt from the offset. Including them would reduce the amount of interest expenses used to calculate the add-on by the amount of interest hospitals earn on funded depreciation. Advocates of this change point out that hospitals have invested their funded depreciation to generate income rather than using it to reduce the level of their outstanding debt. Moreover, they argue that the federal government should not reward hospitals for the resulting increase in their interest expenses. Opponents contend, on the other hand, that the prospective payments for operating costs have not kept up with inflation and that further cuts in federal payments would add to the financial stress some hospitals are experiencing from the PPS.

This option would lower Medicare's outlays by $2.9 billion during the 1989-1993 period. These savings would accrue both because the redefinition would lower the 1988 base amount of capital expenses, and because under the prospective system for capital--which shares the advantages and disadvantages discussed in the previous option--payments are projected to increase more slowly than actual capital costs.

Move Slowly to a Prospective Reimbursement System and Redefine Capital Expenses. Another approach would be to move gradually from the current cost-based system to a prospective one in which capital expenses were redefined. For example, if during a five-year transition period, 95 percent, 80 percent, 60 percent, 40 percent, and 20 percent of the reimbursement in each respective year was based on capital costs as now defined, with the remainder based on the prospective system described in the second option, cumulative savings for fiscal years 1989 through 1993 would be $1.5 billion.

Advocates of this approach argue that continuing partial cost-based reimbursement during a transition period would lessen financial stress for two large groups of hospitals: those with current high capital costs and those planning large capital investments during the transition period. It would also reduce windfall gains for many others whose actual costs would be below Medicare's payments under either of the first two options. Opponents counter that this approach would substantially reduce budgetary savings compared with immediate implementation of a prospective system and that some of the positive incentives of paying prospectively would be delayed.

ENT-06 REDUCE TOTAL MEDICARE DIRECT MEDICAL EDUCATION PAYMENTS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Outlays	170	180	180	190	200	910

Medicare's prospective payment system does not include payments to hospitals for their direct costs of graduate medical education (GME)--that is, residents' and teachers' salaries, administrative costs, classroom expenses, and the associated hospital overhead costs. Instead, these payments are made separately, but also prospectively, based on Medicare's share of the hospital's historical cost per resident. Medicare's GME payments, which are received by about one in six hospitals, represent approximately 2 percent of Medicare's payments for inpatient care, but cover nearly one-third of hospitals' total GME costs.

Several arguments support reducing Medicare's payments for GME. Many observers argue that such subsidies are unwarranted since the United States is facing a projected aggregate surplus of physicians. Moreover, since physicians earn much higher incomes as a result of their GME, they might reasonably contribute more to these costs themselves.

If the Congress were to reduce Medicare's total GME payments by 15 percent, the five-year savings would be about $910 million. (This option would not change training programs for nursing and allied health professions.) Similar savings could be accomplished in several ways: reduce the per-resident payment for every hospital by 15 percent; cap each hospital's per-resident payment at the median; or eliminate per-resident payments to hospitals for graduates of foreign medical schools (FMGs).

Among those who believe Medicare's GME payments should be reduced, advocates of a uniform 15 percent reduction in per-resident payments support it mainly on grounds of fairness. Advocates of a cap suggest that only constraining payments to hospitals with historically high per-resident costs would generally penalize the most inefficient hospitals. Advocates of eliminating payments to FMGs favor discouraging their employment because of concerns about their quality as well as their contribution to projected surpluses of physicians.

Reducing Medicare's GME payments could have some drawbacks, however. Many hospitals have built their training programs based on expectations of Medicare's reimbursements for GME. Decreasing or eliminating Medicare's GME payments could force some programs to reduce the resources they commit to training, or even to close. This response could, in turn, reduce access to health care services in some communities.

ENT-07 ADOPT A FEE SCHEDULE FOR REIMBURSING PHYSICIANS UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Fee Schedule with Rates Updated Annually by the MEI						
Outlays	150	370	520	680	880	2,600
Fee Schedule with Spending Cap Set by the MEI						
Outlays	1,050	3,130	5,140	7,440	10,000	26,760
Fee Schedule with Spending Cap Set by Growth in GNP						
Outlays	680	2,390	4,330	6,540	8,990	22,930

Medicare currently reimburses physicians under the Supplementary Medical Insurance (SMI) program for "reasonable" charges for all covered services. A reasonable charge for a given service is the lowest of the physician's actual charge, the physician's customary charge for that service, or the prevailing charge for that service in the local community. This practice is known as the customary, prevailing, and reasonable (CPR) system.

Because of the automatic and inflationary link between physicians' actual charges and Medicare's payment rates in the next year, the CPR system has been criticized for contributing unnecessarily to cost increases. To weaken this link, since 1973, the allowed rate of increase in prevailing fees has been limited to the rate of increase in an economywide index of office expenses and earnings--the Medicare Economic Index (MEI). Because only about half of all physicians' customary charges are at the ceiling set by MEI-adjusted prevailing fees, however, and because increases in customary charges typically exceed MEI increases, the rate of increase in payment rates has exceeded increases in the MEI.

Rates Updated Annually by the MEI. One alternative to the CPR system would be to implement a Medicare fee schedule for physicians' and related services--with adjustment for local differences in costs. A fee schedule could perhaps be put in place by January 1, 1989. (Under the Omnibus Budget Reconciliation Act of 1987, a fee schedule for radiology services alone is already required for 1989.) The fee schedule that would be effective during 1989 could be set at the average amounts allowed for each service during 1988, with increases in payment rates for 1989 and each year thereafter determined by the rate of increase in the MEI. Savings under this option would be $150 million for fiscal year 1989. Savings would total $2.6 billion over the 1989-1993 period, reducing net SMI outlays by about 1.2 percent.

A fee schedule based on average allowed amounts would incorporate elements of the current fee structure that many people believe need to be corrected. For example, current amounts may include excessive payments for certain procedures that are either ineffective or far less costly to perform now than when they were first introduced. The rate structure could be modified incrementally after it has been put in place, or changes in physician payment methods could be delayed for a year or two until a more appropriate fee structure was developed. (The Health Care Financing Administration has awarded a contract to develop a relative value scale that could serve as the basis for a fee schedule; completion is scheduled for mid-1988.)

Moreover, control of total costs in a fee-for-service payment system probably requires constraints on the volume of services as well as on fees. Without volume controls, some physicians might respond to constraints on fees by providing additional reimbursable--but unnecessary or only marginally useful--services.

Spending Cap Set by the MEI. Other countries have successfully contained increases in volume under fee-for-service systems by using a combination of two mechanisms: volume-related adjustments in payment rates to cap total spending for physicians' services, together with a systematic monitoring of practice profiles to prevent individual physicians from making above- average increases in their billings at the expense of other physicians. If increases in the average approved charges per enrollee were limited by increases in the MEI--so that payment rates would be reduced to offset increases in the average volume per enrollee--savings under the fee schedule discussed above would increase to $1.1 billion for 1989 and would total $26.8 billion over the five-year period. Some increases in the average volume of services per enrollee might be desirable, however, to account for aging of the Medicare population and medical advances.

Spending Cap Set by Growth in GNP. Average charges per SMI enrollee could be permitted to increase by the growth in physicians' practice costs plus an appropriate allowance for effects on costs resulting from the aging of the Medicare population and from advances in technology, before triggering a downward adjustment in payment rates. The appropriate allowances for these factors could be difficult to determine, however. To do so would be especially difficult for medical advances, which might either increase or reduce the variety and costs of services that could benefit enrollees.

One option would be to allow total charges per SMI enrollee to increase each year according to growth in GNP. Consequently, some increase in the volume of services per SMI enrollee would be permitted so long as payment rates increased less rapidly than GNP. Savings under this option would be $680 million for 1989 and $22.9 billion over the five-year projection period, but the allowed growth in volume could be greater or less than that warranted by aging and technological change.

Other Approaches. Alternative methods could reduce the undesirable incentives for volume by basing reimbursements on more comprehensive packages of services--such as all services required by enrollees during a specified period of time (capitation). Before this kind of alternative could become the dominant payment method for physicians' services under Medicare, however, a number of issues about implementation and feasibility would need to be resolved. Implementation of a fee schedule now would not prevent more fundamental changes in payment methods later, when acceptable alternative approaches are developed.

ENT-08 INCLUDE HOSPITAL-BASED PHYSICIANS' SERVICES IN HOSPITALS' PROSPECTIVE PAYMENTS

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Outlays	80	190	300	420	550	1,540

Radiologists, anesthesiologists, and pathologists (RAPs) are supporting physicians who often have contractual arrangements with hospitals that grant them exclusive rights to provide services to hospitals and their inpatients. These contractual arrangements typically cover payment provisions for certain administrative services provided to the hospitals by RAPs, but not for their patient-related services. Instead, RAPs bill patients (or their insurers) directly, on a fee-for-service basis. Because hospitals select the RAPs who will provide services to their inpatients, however, hospitals are in a better position than patients to negotiate with these hospital-based physicians.

Medicare could eliminate fee-for-service reimbursement for the inpatient services provided by RAPs. Instead, the hospitals' DRG payments under Part A of Medicare could be expanded to reflect the costs of all services provided by RAPs to hospital inpatients, with payments to RAPs constrained to grow at the same rate as DRG payments in future years. Outpatient services provided by RAPs would continue to be paid as under current law, including the fee schedules for radiology services that would be implemented in 1989 under the Omnibus Budget Reconciliation Act of 1987.

If this change was carried out beginning January 1, 1989, with each DRG rate for 1988 first increased by the average cost to Medicare in 1988 for services provided by RAPs to patients in that DRG and then updated by an appropriate price index, savings would be $80 million in fiscal year 1989. Savings would total about $1.5 billion over the five-year projection period, reducing Medicare's net outlays for physicians' services by about 0.7 percent. These estimates assume that shifting costs to the outpatient sector would be prevented for the most part by, for example, denying payment for related RAP services provided within seven days on either side of an inpatient stay.

This option would give hospitals incentives they now lack to negotiate reasonable rates of pay for RAPs and to use their services efficiently. As a result, payments for the services provided by RAPs would be lower under this payment method than under the current system, thus reducing both Medicare's and patients' costs. In fact, coinsurance and balance-billing amounts for which patients are currently liable under Part B of Medicare would be eliminated on inpatient services provided by RAPs. Consequently, out-of-pocket costs for patients would drop by a higher percentage than Medicare's costs.

Either RAPs or hospitals, however, would be worse off under this option. Total payments to RAPs for services to Medicare inpatients would fall, unless hospitals accepted the loss by paying RAPs more, on average, than the amount by which DRG rates were increased. The allocation of this reduction in receipts between RAPs and hospitals would vary by locality, depending on the extent of competition for the services of RAPs. The reduction in Medicare receipts that would occur under this option might adversely affect access for Medicare enrollees in some isolated areas. But this effect would not be widespread because RAPs are among the most highly paid physician specialists and because most hospitals have fared well under the prospective payment system.

ENT-09 INCREASE MEDICARE'S PREMIUM FOR PHYSICIANS' SERVICES

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Set Premiums to Cover 30 Percent of Costs						
Outlays	1,480	2,520	3,520	4,780	6,200	18,500
Set Premiums to Cover 50 Percent of Costs						
Outlays	7,400	11,100	13,220	15,770	18,620	66,110

Medicare's Supplementary Medical Insurance (SMI) program is partially funded by monthly premiums--currently $24.80--paid by enrollees. Between 1972 and 1982, premium receipts covered a declining share of SMI costs--dropping from 50 percent to 25 percent--because premiums were tied to the rate of growth in Social Security benefits, which is based on the Consumer Price Index, rather than on the faster-rising per capita cost of SMI. (The remaining costs are paid from general revenues.)

In 1982, premiums were set through 1985 (later extended through 1989) to cover 25 percent of the average benefits for an aged enrollee. Under current law, beginning in 1990 the premium calculation will again be limited to the rate of growth of Social Security benefits. If, instead, the premium were set so that enrollees would pay 30 percent of benefits beginning January 1, 1989, and for all years thereafter, federal savings would total $1.5 billion in fiscal year 1989 and $18.5 billion over the five-year period. The estimated monthly premium would be $32.10 on January 1, 1989, instead of the scheduled $26.80. Net outlays for SMI would be reduced by about 8 percent over the five-year period. If the premiums were set to cover 50 percent of costs (as they did before 1972), the monthly premium for 1989 would be $53.50. Savings would be $7.4 billion for 1989, and $66.1 billion over the five-year period, reducing net outlays by about 28 percent.

Under this option, the increase in payments would be shared by all SMI enrollees, in contrast to proposals--such as increasing copayments--that would affect only the users of medical services, who may be financially pressed during their period of illness. Also, this option would not affect the poorest enrollees because they are likely to be eligible for Medicaid, which usually pays the SMI premium on their behalf. For those not eligible for Medicaid, the 30 percent premium would be about 6 percent of the average monthly Social Security benefit in 1989, somewhat more of a burden than in 1967--the first full year for Medicare--when the premium was 3.6 percent of the average Social Security benefit. The 50 percent premium would be about 10 percent of the average Social Security benefit, making it a significantly higher burden than in 1967.

Low-income enrollees who are not eligible for Medicaid, however, could find the increased premium burdensome. A few might drop SMI coverage and either do without care or turn to sources of free or reduced-cost care, which could increase demands on local governments. In addition, the costs for states would increase for Medicaid-eligible Medicare enrollees because states would pay part of the higher premium costs for those enrollees.

ENT-10 USE THE TAX SYSTEM TO IMPOSE A SUPPLEMENTARY INCOME-RELATED PREMIUM FOR PHYSICIANS' SERVICES

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Addition to CBO Baseline	0.7	2.4	2.6	2.8	3.1	11.5

Part B of Medicare offers Supplementary Medical Insurance (SMI), which covers a portion of Medicare enrollees' physician and other nonhospital charges. Participation is voluntary, and enrollees currently pay a monthly premium of $24.80. Estimated premium receipts for 1988 will be $8.8 billion. The balance of costs, about $26.5 billion, will be paid from general revenues.

An alternative to increasing the share of costs financed by the premium would be to impose a supplementary income-related premium that would be paid by all SMI enrollees. To avoid having to set up a new bureaucracy to collect these premiums from enrollees, this option could be most conveniently implemented through the income tax system. This approach would exempt from the special tax those individuals who chose not to enroll in the SMI program.

A 1 percent tax, for example, could be imposed on enrollees' taxable income. A ceiling on added tax liability for each tax filing unit (usually an elderly individual or couple) could be set by the number of SMI enrollees in the unit times the average value of subsidized SMI benefits per enrollee. In this way, no unit would pay more than the full insurance value of its benefits. If an SMI tax of 1 percent was imposed on taxable income for all units with at least one SMI enrollee during the tax year (prorated for part-year enrollment), revenues earmarked for the SMI trust fund would be increased by $0.7 billion in 1989, and by $11.5 billion over the 1989-1993 period. Five-year revenues would equal about 5 percent of SMI net outlays.

In contrast to the premium discussed in ENT-09, this approach would fall less heavily on low-income enrollees and more heavily on those with high incomes. The poorest enrollees--those with no taxable income--would not be affected, whether or not they were eligible for Medicaid benefits. The amount paid would vary directly with the amount of taxable income. As a result, individuals with taxable income below $6,360 a year would pay less under this approach, while those with taxable income above $6,360 would pay more than if premiums were increased to cover 30 percent of costs. The effect on low- and moderate-income enrollees could be reduced still further by using personal income tax rates--as in ENT-11--rather than the proportional tax used in this option.

Some people might consider this tax inequitable because the amount of tax paid by each tax unit would not vary with the number of SMI enrollees in a unit, except for a small number of high-income tax units affected by the ceiling. In addition, some might question the use of taxable income (which excludes Social Security benefits for most taxpayers) as the base for the special tax, because these benefits contribute to enrollees' ability to pay for Medicare.

Variations of this proposal are included in both the House and the Senate versions of H.R. 2470, the catastrophic health bill that is currently awaiting conference. If either version of the catastrophic health bill is enacted, the potential for savings from this option would be preempted to a considerable extent.

ENT-11 TAX A PORTION OF MEDICARE BENEFITS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
With Income Threshold	0.9	3.1	3.8	4.5	5.3	17.5
Without Income Threshold	1.8	6.4	7.3	8.4	9.4	33.3

Eligibility for Hospital Insurance (HI) benefits is based on working-year tax contributions, half of which are paid by employees from after-tax income and half by employers from pretax income. Eligibility for Supplementary Medical Insurance (SMI) depends on payment of a premium, which currently covers about 25 percent of SMI benefits. Hence, 50 percent of the insurance value of HI benefits--that portion of contributions that were not originally subject to income tax--and that portion of the insurance value of SMI benefits not paid by premiums might be treated as taxable income for enrollees. (The resulting tax proceeds could be returned to the Medicare trust funds.) This proposal is analogous to taxing part of Social Security benefits, which is already part of the law for beneficiaries for whom modified adjusted gross income plus half of Social Security benefits exceeds $25,000 (for individuals) or $32,000 (for couples) (see REV-16).

If the current income thresholds for the tax on Social Security benefits were also used to limit the application of the tax on Medicare benefits--with the portion of Medicare benefits described above added to modified adjusted gross income plus half of Social Security benefits to compare with the threshold--then taxing both HI and SMI benefits would yield additional revenues of $0.9 billion in 1989 and $17.5 billion over the 1989-1993 period. If no income thresholds were used to limit the application of the Medicare tax, additional revenues would be $1.8 billion in 1989 and $33.3 billion over the five-year period.

A tax on HI benefits would strengthen the HI trust fund. A tax on SMI benefits would shift some SMI costs from the general taxpayer to enrollees, without increasing costs for low-income enrollees and therefore not threatening their access to care. Moreover, if income thresholds were used, even middle-income enrollees would be protected from additional liability under this option. In contrast to ENT-10, people enrolled in the SMI program would never pay the full insurance value of their benefits under this option, since the maximum personal income tax rate to be applied to the subsidy value of benefits would be 33 percent under current law. Further, since this option would use the mechanism already in place for taxing Social Security benefits, it would present no additional administrative difficulty.

Unlike the tax on Social Security benefits, though, this tax would be imposed on the insurance value of in-kind benefits rather than on dollar benefits actually received--a modification of current tax policy. (If the tax were imposed on actual benefits received, however, the Medicare tax would be directly related to enrollees' health-care costs, reducing the insurance protection Medicare is intended to provide.) In addition, some people might object to this option because enrollees could not alter their tax liability by choosing a different package of benefits, except by dropping SMI or all Medicare coverage. Finally, the additional tax liability could be substantial for some enrollees--nearly $550 in 1989 for those in the 28 percent tax bracket, although most Medicare enrollees would be in a lower tax bracket or unaffected by the proposal.

Variations of this proposal are included in both the House and the Senate versions of H.R. 2470, the catastrophic health bill that is currently awaiting conference. If either version of the catastrophic health bill is enacted, the potential for savings from this option would be preempted to a considerable extent.

ENT-12 INCREASE MEDICARE'S DEDUCTIBLE FOR PHYSICIANS' SERVICES

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Outlays	1,100	1,980	2,480	2,970	3,560	12,090

Appreciable federal savings in Medicare's Supplementary Medical Insurance (SMI) program could be realized by increasing the deductible--that is, the amount that enrollees must pay for services each year before the government shares responsibility. The deductible is now $75 a year. This deductible has been increased only twice since Medicare began in 1966, when it was set at $50. Hence, the deductible has fallen relative to average per capita benefits from 70 percent in 1967 to less than 8 percent for 1987. Increasing the SMI deductible to $200 on January 1, 1989, and indexing it thereafter to the rate of growth in SMI charges per enrollee would save $1.1 billion in fiscal year 1989. Savings would total $12.1 billion over the five- year period from 1989 through 1993, reducing SMI outlays by about 5 percent.

Such an increase would spread the burden of reduced federal outlays among most enrollees, raising their out-of-pocket costs by no more than $125 each in 1989 (which would be partially offset by reduced premium costs of $1.20 a month). Since a larger proportion of enrollees would not exceed the deductible (currently about 30 percent do not), it would both increase the number of enrollees with strong incentives for prudent consumption of medical care and reduce administrative costs to process claims.

On the other hand, even relatively small increases in out-of-pocket costs could prove burdensome to low-income enrollees who do not receive Medicaid, which generally pays deductible amounts for dual Medicaid-Medicare beneficiaries. That added expense might, in turn, discourage some people from seeking needed care.

ENT-13 TAX EMPLOYER-PAID HEALTH INSURANCE

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Tax Some Employer-Paid Health Insurance						
Income Tax	3.5	5.5	6.3	7.2	8.1	30.6
Payroll Tax a/	1.9	3.0	3.5	3.9	4.5	16.9
Total	5.5	8.6	9.8	11.1	12.6	47.5
Tax Employer-Paid Health Insurance but Allow a Credit for Some Employer and Employee Contributions						
Income Tax	10.8	3.2	3.9	4.8	5.9	28.6
Payroll Tax a/	9.7	14.9	16.3	17.7	19.2	77.8
Total	20.5	18.1	20.2	22.5	25.1	106.4

a. Estimates are net of reduced income tax revenues.

Employees do not pay taxes on income received in the form of employer-paid health care coverage. This exclusion will reduce 1989 income tax revenues and Social Security payroll tax revenues by a total of about $40 billion.

Tax Some Employer-Paid Health Insurance. One proposal to limit the exclusion would be to treat as taxable income any employer contributions (including those in cafeteria plans and flexible spending accounts) that exceed $225 a month for family coverage and $90 a month for individual coverage (in 1989 dollars), with these amounts indexed to reflect future increases in the general level of prices. This proposal would raise income tax revenues by about $31 billion and payroll tax revenues by about $17 billion over the 1989-1993 period. Including employer-paid health care coverage in the Social Security wage base, however, would lead to increased outlays on benefit payments that would offset most of the added payroll tax revenues from this option over the long run. This proposal would also raise individual income tax revenues for states whose tax base is linked to the federal tax base, unless they took offsetting action.

An advantage of this approach is that it would eliminate the present tax incentive to purchase additional coverage beyond the ceiling. In the absence of such coverage, there would be stronger incentives to economize in the medical marketplace and reduced upward pressure on medical care prices. Over the long run, indexing the ceilings would limit their erosion by inflation. Finally, the Congress has already limited the exclusion for employer-paid group life insurance (see REV-18).

One disadvantage of limiting the tax subsidy is the difficulty of determining just when extensive coverage becomes excessive. Moreover, a uniform ceiling would have uneven effects, since a given employer's contribution purchases different levels of coverage depending on such factors as geographic location and the demographic characteristics of the firm's workforce. Finally, the indexing provision of this proposal would lead to declining subsidies for employer-paid health insurance over time, if health insurance costs continue to rise faster than the general level of prices. This effect is of concern to people who argue that these subsidies to private-sector benefits help avoid the need for public provision of the same benefits.

Tax Employer-Paid Health Insurance but Allow a Credit for Employer and Employee Contributions. Another option would be to treat all employer-paid health insurance premiums as taxable but offer an individual income tax credit of 20 percent for health insurance premiums up to the amounts described above for family and individual coverage. The credits would be available to taxpayers regardless of whether the coverage was paid for or sponsored by an employer. At this credit percentage and with these premium ceilings, the proposal would increase income tax revenues by about $29 billion and payroll tax revenues by about $78 billion over the 1989-1993 period. As under the first option, however, increases in Social Security outlays would offset most of the added payroll tax revenues in the long run. This proposal would substantially raise individual income tax revenues for states whose tax base is linked to the federal tax base, unless they took offsetting action.

In addition to eliminating the tax incentive to purchase health insurance above the limits, as under the first option, an added advantage is that the subsidy would be made available to taxpayers without regard to their employment status. Moreover, the subsidy per dollar of eligible health insurance coverage purchased would not be higher for taxpayers with higher incomes. A drawback of this option is that the benefits of the tax credit would not be available to low-income individuals and families who have no liability under the federal personal income tax, unless the credit was made refundable. Such a refund would, however, substantially reduce the net revenue gain discussed above. Moreover, as with the first option, it would be difficult to determine at what level health insurance coverage becomes excessive.

ENT-14 REQUIRE A TWO-WEEK WAITING PERIOD FOR UNEMPLOYMENT INSURANCE BENEFITS

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Outlays	--	1,150	1,200	1,300	1,350	4,950

NOTE: These estimates assume that the change is not implemented until fiscal year 1990, to allow time for changes in state Unemployment Insurance laws.

Current federal law imposes no mandatory waiting period before jobless workers can receive Unemployment Insurance (UI) benefit payments, although the Omnibus Reconciliation Act of 1980 does require states to adopt a one-week waiting period on regular UI benefit payments or lose some federal benefits under the extended UI program. About three-quarters of the states now require a one-week waiting period for regular UI benefits.

If all jobless workers were required to wait two weeks before receiving UI benefits, program outlays would be reduced and beneficiaries in all states would be treated uniformly. Such a change would not affect the maximum length of time during which workers could collect benefits; for example, a person otherwise eligible for 26 weeks of benefits would retain that eligibility but would receive payments for weeks 3 through 28 of joblessness. Benefits would be reduced, however, for those recipients not using the maximum number of covered weeks. If established in 1990 (to allow time for states to change their UI laws), this option would cut UI outlays by nearly 7 percent, or by about $5 billion between then and 1993.

This option could reduce the incentive of workers to become unemployed and collect UI benefits by increasing the initial cost of joblessness, yet it would not greatly affect the program's ability to help the long-term unemployed. Restricting aid in this way might lower the number of workers who apply for assistance and reduce the duration of benefits paid to many who do apply.

On the other hand, because this change would reduce the benefits provided to jobless workers who do not use all of their entitlement, it would diminish the income support role of UI. In addition, covered workers are now entitled to benefits soon after they become unemployed, so that this change would erode the insurance protection of UI. Finally, this change would impose additional federal restrictions on state UI programs, even though it is state UI taxes that finance regular UI benefits.

ENT-15 REDUCE THE SUBSIDY FOR NONPOOR CHILDREN IN CHILD NUTRITION PROGRAMS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	310	330	360	380	400	1,770
Outlays	290	330	350	370	390	1,740

Federal child nutrition programs were developed to improve the health and well-being of children by providing them with nutritious meals. The programs provide cash and commodity assistance to schools, child-care centers, and family day-care homes that serve meals to children. Although most of the funds are targeted toward low-income children, some of the aid benefits middle- and upper-income children as well. For example, in the National School Lunch Program (the largest of the child nutrition programs), most schools receive $1.41 in cash reimbursement for each meal served to children from households with incomes at or below 130 percent of the poverty line; a smaller subsidy of $1.01 for each meal served to children from households with incomes between 130 percent and 185 percent of poverty; and a subsidy of 13.5 cents per meal for children with household incomes above 185 percent of poverty. Schools are also given 12 cents' worth of commodities for each lunch served, regardless of the household income of the child. Comparable reimbursement structures are used in the School Breakfast Program and in the child-care center portion of the Child Care Feeding Program.

Eliminating the cash reimbursement for all meals served to children from households with incomes above 185 percent of the poverty line ($20,720 per year for a family of four in the 1986-1987 school year) would reduce federal expenditures by about $290 million in 1989, and by about $1,740 million over the 1989-1993 period. These estimates assume that all participating schools and child-care centers would remain in the program. With lower total subsidies, however, some of these organizations might choose to drop out of the program, especially if few children remained eligible for federal subsidies. A decrease in the number of schools and centers participating would increase federal budgetary savings, since fewer children and organizations would receive subsidies.

Although most of the federal funds were targeted toward low-income children, 51 percent of the school lunches served in fiscal year 1987 went to children whose household income was above 185 percent of the poverty line. These children are less in need of federal subsidies, and the targeting of this assistance would be improved by limiting it to those from households with the lowest incomes.

Such a change is likely to result in lower participation among nonpoor children, because participating schools and centers would probably make up the loss in reimbursements by increasing the price charged to this group. It is not known, however, how many children might drop out of the program. Any decline could lead to lower quality meals for some students, because the meals qualifying for reimbursement are nutritionally adequate, while those from alternative sources may not be. Moreover, if the decline were substantial, low-income children could become the main recipients of the meals and thus would be identifiable as poor by their peers. Finally, if the participation of nonpoor children helps schools and child-care centers hold down their overall per-meal preparation and service costs, lower participation by this group could cause these organizations to drop out of the program, thereby denying federally subsidized meals to low-income children.

ENT-16 INCREASE THE STATES' SHARE OF AFDC, MEDICAID, AND FOOD STAMP BENEFIT COSTS a/

Savings from CBO Baseline	Annual Savings (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Eliminate the Floor on the AFDC and Medicaid Matching Rates						
Budget Authority	5.6	6.1	6.6	7.2	7.8	33.3
Outlays	5.6	6.1	6.6	7.2	7.8	33.3
Require States to Pay a Proportion of Food Stamp Benefits						
Budget Authority	0.6	0.6	0.6	0.7	0.7	3.2
Outlays	0.6	0.6	0.6	0.7	0.7	3.2

a. The AFDC and the Food Stamp programs are in budget function 600; Medicaid is in function 550.

The federal government and the states jointly fund benefits in the Aid to Families with Dependent Children (AFDC) and Medicaid programs, whereas the federal government entirely funds Food Stamp benefits, with no state contribution. This option would lower the federal share in financing benefits for all of these programs by eliminating the floor on the AFDC and Medicaid matching rates, and by requiring states to pay a proportion--for illustration, 5 percent--of the cost of Food Stamp benefits. Total federal outlays would be reduced by $6.2 billion in 1989 and by $36.5 billion over the next five years.

Eliminate the Floor on the AFDC and Medicaid Matching Rates. The federal share of costs for both the AFDC and Medicaid programs varies with state per capita income, with high-income states paying a larger share of benefits than low-income states. By law, the federal share can be no less than 50 percent and no more than 83 percent. The 50 percent federal matching rate applied to 12 states in fiscal year 1989. [1] The current system of setting the federal matching rate, a sliding scale with a floor, requires low- and middle-income states to pay a greater share of AFDC benefits and Medicaid costs relative to income than it requires of high-income states. If the floor were removed, the federal share would decrease as far as 21.96 percent for Connecticut. The federal contribution levels would then be directly related to state income, as the contributions for middle- and lower-income states currently are. Federal savings for the AFDC program would be $1.4 billion in 1989 and $7.3 billion over the 1989-1993 period; outlays would be reduced for Medicaid by $4.2 billion in 1989 and $26.0 billion over the five-year period. 2/

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[1] The states affected by this option include Alaska, California, Colorado, Connecticut, the District of Columbia, Illinois, Maryland, Massachusetts, Nevada, New Hampshire, New Jersey, and New York.

Seven of the twelve states affected by this proposal paid AFDC benefits in fiscal year 1987 that were in the upper third when states were ranked by the size of benefits. Four of the other five paid benefits near the median benefit levels in the country. Eight of the states cover the medically needy under their Medicaid program. If the high-income states wish to set high AFDC benefit levels and offer more generous Medicaid programs, one might argue that these states, rather than the federal government, should pay more of the cost.

On the other hand, the high incomes and benefit levels in these states may in part reflect the higher cost of living in these states. The relatively large savings from this proposal would come entirely from only 12 states, and even among these states the burden would be unevenly distributed. Three states--California, New York, and New Jersey--would bear three-quarters of the new costs. If this proposal were adopted, the states affected would need to compensate for the lost revenue by reducing expenditures on AFDC and Medicaid, by raising taxes, or by lowering spending on other state services. If states chose to compensate by reducing AFDC and Medicaid expenditures, recipients of these programs would be adversely affected. If the states chose to raise taxes or reduce other spending, most state residents would be likely to share the burden of the higher state costs.

Require States to Pay a Proportion of Food Stamp Benefits. The Food Stamp program offers coupons redeemable for food to families with low incomes and low levels of assets. These benefits are funded

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2. If the floor on the matching rate were instead reduced from 50 percent to 48 percent, the five-year savings from AFDC and Medicaid would be $6.1 billion.

entirely by the federal government. States currently do not pay any share of Food Stamp benefits, but they pay one-half of most state and local administrative costs. This proposal would require the states to share a proportion of Food Stamp benefit costs. For illustration, the table shows federal savings when states pay 5 percent of those costs. Federal savings would be $0.6 billion in 1989 and $3.2 billion over the 1989-1993 period.

Paying a share of benefits would give states a financial stake in the program, increasing their incentive to determine benefit levels more accurately. In addition, states currently have little financial incentive to put effort into designing employment and training programs that will successfully move able-bodied recipients off the Food Stamp program and into jobs. This proposal might provide such an incentive.

On the other hand, since benefits in the Food Stamp program are determined by the same rules nationwide, this proposal would be more difficult for low-income states to fund than high-income states. The low-income states might respond by cutting already low benefits in programs like AFDC. In addition, states might object to paying a share of the cost of benefits for a program in which they have no discretion to set either eligibility conditions or benefit levels.

ENT-17 COUNT ENERGY ASSISTANCE AS INCOME IN AFDC AND IN FOOD STAMPS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	245	255	265	275	285	1,330
Outlays	245	255	265	275	285	1,330

The Low Income Home Energy Assistance Program (LIHEAP) provides more than $1 billion each year to help pay the energy bills of over six million low-income families, many of whom also receive Aid to Families with Dependent Children (AFDC) or food stamps. LIHEAP funds are allocated to states for payment either to households or to energy suppliers on behalf of eligible households. At state option, households with members receiving AFDC are categorically eligible for LIHEAP aid.

Regardless of how it is paid, LIHEAP assistance is currently ignored in determining either eligibility or benefit levels in AFDC and the Food Stamp program. This option would count LIHEAP payments as income in both programs, but would limit the amount counted as income in AFDC to no more than the energy portion of the need standard. The federal government would save roughly $245 million in fiscal year 1989 and $1.3 billion over the next five years, as some families would become ineligible for AFDC or food stamps, while others would have their benefits reduced. Roughly one-fourth of the savings would be in AFDC and three-fourths in food stamps.

Counting LIHEAP aid as income would recognize that assisted families are better off than their unassisted counterparts because part of their energy bills are paid by the government, leaving them more of their own income to meet other needs. In this sense, AFDC and food stamp families receive duplicate aid when LIHEAP payments are ignored in determining benefits.

On the other hand, federal law requires that states, in distributing LIHEAP funds, give preference to households with the highest energy costs. Assistance payments should thus serve primarily to meet extraordinary energy needs. Counting that aid as income would lower both AFDC and Food Stamp benefits--or push families off the programs altogether--and thus markedly reduce any gains from the energy assistance. Compared with the current system, this approach would particularly penalize families facing large energy bills.

ENT-18 MODIFY PROVISIONS OF THE AFDC PROGRAM

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Eliminate Caretaker Benefits When Youngest Child Turns 16						
Budget Authority	120	130	135	150	155	690
Outlays	120	130	135	150	155	690
Reduce Federal Matching Rate for Administrative Costs						
Budget Authority	305	315	325	335	340	1,620
Outlays	305	315	325	335	340	1,620

The Aid to Families with Dependent Children (AFDC) program provides cash assistance to families with children in which one parent is absent or incapacitated, or--in about half of the states and the District of Columbia--when the primary earner is unemployed. Payments are based on state-determined standards that vary with the number of covered children and adult caretakers. Eligibility ends when a child turns 18, although states may elect to provide aid for an additional year for full-time students who will complete high school or other approved courses of study before turning 19. The federal government pays between 50 percent and 79 percent of benefit costs and half of administrative costs, and states pay the balance.

The two program changes described here would save a total of about $425 million in fiscal year 1989 and $2.3 billion over the five-year period from 1989 through 1993.

Eliminate Benefits for Caretakers When the Youngest Child Reaches Age 16. AFDC payments are based on the number of people in the AFDC unit, including adult caretakers on the assumption that they are needed in the home and therefore cannot work at paid employment. Excluding adult caretakers from the benefit calculation when the youngest child turns 16 would save about $120 million in fiscal year 1989 and $690 million over five years. This proposal assumes that children over age 15 are capable of taking care of themselves during the day and that lower benefits would encourage caretakers to get jobs. Moreover, benefits would decline gradually, rather than ending abruptly when the youngest child turns 18 and the family is no longer eligible. On the other hand, eliminating benefits for caretakers might reduce the resources available to support the children. If so, children might not be helped as much as the program intends. Furthermore, some object to leaving 16- or 17-year-olds unattended while their parents work, something that would be more likely under this proposal.

Reduce the Federal Match for Administrative Costs from 50 Percent to 40 Percent. State costs of administering the AFDC program are currently divided evenly between the federal government and the states. Reducing the federal share from 50 percent to 40 percent would save about $305 million in fiscal year 1989 and $1.6 billion over the next five years. It might encourage states to improve the efficiency of agencies administering the AFDC program, since they would bear a larger part of the costs of inefficiencies, thereby lowering overall program costs. On the other hand, states might try to save administrative costs by reducing the amount of time spent handling AFDC cases, and consequently make more errors in benefit payments. In addition, this proposal might encourage states to reduce benefit levels and other services (such as administering work programs) to constrain state costs, and thus might harm recipients. Furthermore, it is questionable whether the ten-percentage-point rise in the state share of costs would have any significant effect on administrative efficiency.

ENT-19 ELIMINATE THE $50 CHILD-SUPPORT PAYMENT TO AFDC FAMILIES

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	125	135	155	170	195	780
Outlays	125	135	155	170	195	780

The Child Support Enforcement (CSE) program collects child support payments on behalf of families receiving Aid to Families with Dependent Children (AFDC). These payments are used to offset federal and state costs for AFDC. Up to the first $50 in monthly child support collected, however, is paid to the AFDC family, with no effect on the level of AFDC benefits. In essence, this policy means that AFDC families for which absent parents contribute child support get as much as $50 more per month than otherwise identical families for which such contributions are not made. (This policy is sometimes referred to as the child-support disregard in the AFDC program, since it is equivalent to not counting the first $50 of child support as income in calculating AFDC benefits.)

Eliminating the $50 child-support payment to AFDC families would save the federal government about $125 million in fiscal year 1989 and $780 million over the next five years. Stopping such payments would also end the differential treatment of AFDC families that depends on whether the absent parent pays child support.

On the other hand, the family payment currently provides incentives both for absent parents to pay child support and for custodial parents to make an effort to obtain support. If the payment were eliminated, AFDC recipients would be no better off when absent parents pay child support, and would thus be less inclined to seek such payments. Furthermore, because their contributions would not improve the well-being of their children, absent parents would be less inclined to act responsibly in giving their children financial support.

ENT-20 MAKE MISCELLANEOUS CHANGES TO CHILD SUPPORT ENFORCEMENT

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Mandate Guidelines for, and Require Periodic Updating of, Child Support Obligations						
Budget Authority	5	35	70	110	145	365
Outlays	5	35	70	110	145	365
Reduce the Federal Matching Rate for CSE Costs						
Budget Authority	165	175	185	200	215	940
Outlays	165	175	185	200	215	940

Enacted in 1975, the Child Support Enforcement (CSE) program provides states with both administrative tools and funding with which to improve the payment of child support by absent parents. The two changes described in this option would generate budget savings of about $170 million in 1989 and $1.3 billion over the next five years.

Mandate Child-Support Guidelines and Require Periodic Updating of Child-Support Obligations. In 1985, about $7.2 billion in child-support payments were paid to 3.2 million mothers of children with absent fathers. Child support made up about 15 percent of total income for families receiving some child support, and 27 percent of total income for those below the poverty level. In an attempt to increase child support obligations and to make them more uniform, the 1984 amendments to the CSE program required states to develop guidelines to be considered in determining the support obligations of absent parents, but did not require that judges or other officials use those guidelines in setting payment levels. This proposal would require that authorities use the guidelines in setting child-support payment levels--although exceptions could be made if justified--and that payment levels be revised periodically to take account of changing economic circumstances.

As a result, new child support obligations would be established at higher levels and some existing ones would be raised, causing an increase in AFDC child support collections retained by the federal government and probably resulting in some reduction in Aid to Families with Dependent Children (AFDC), food stamps, and other federal benefits. (Some existing child support obligations would be reduced under the guidelines. While increases in obligations are generally expected to be far more common than decreases, individual changes and aggregate effects are difficult to predict with confidence.) Federal spending would fall by an estimated $5 million in 1989 and $365 million over the 1989-1993 period. In addition, this option would raise the incomes of many single-parent families, a large fraction of whom have incomes below the poverty line. Furthermore, by removing much of the discretion authorities now have, this policy would also lead to greater uniformity of support levels among similar families, and would maintain that uniformity over time. On the other hand, because deviating from the guidelines would entail additional justification, judges might be less willing to vary child-support levels to take account of legitimate differences in family circumstances not considered in the guidelines. Also, there would still be wide variation in guidelines, and hence in child-support awards, among states.

Reduce the Federal Matching Rate on CSE Costs by Ten Percentage Points. In fiscal years 1988 and 1989, the federal government will pay 68 percent of the costs of CSE; for fiscal year 1990 and the future, the rate will drop to 66 percent. Reducing those matching rates to 58 percent in 1989 and 56 percent in subsequent years would save about $165 million in 1989 and $940 million over the 1989-1993 period. In addition, it would encourage states to improve the efficiency of their CSE efforts, since they would pay a larger share of the costs of inefficiencies, and could thus lead to lower program costs overall.

On the other hand, this option might prompt states to cut CSE services to hold down costs, and might therefore result in reduced child support collections on behalf of both welfare and nonwelfare families. While the lower CSE collections for AFDC families would decrease state revenues from that source, states still might be better off financially, since their share of collections can be as little as 17 percent. Depending on how much child support collections for welfare recipients would drop as spending on CSE was reduced, the revenues that states could lose as a result of lower CSE collections might be less than what they would save by reducing CSE services. Further, states receive only small financial benefits from non-AFDC child support collections, so they might be even more likely to cut back on CSE efforts on behalf of nonwelfare families. While any reductions in total CSE spending would add to federal savings, children with absent parents would probably be worse off. Finally, it is questionable whether a ten-percentage-point reduction in the matching rate would have a marked effect on the efficiency with which states carry out their CSE efforts.

ENT-21 LIMIT THE SOCIAL SECURITY COST-OF-LIVING ADJUSTMENT TO THE LESSER OF EITHER THE INCREASE IN WAGES OR THE INCREASE IN THE CONSUMER PRICE INDEX

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Social Security/ Railroad Retirement	2,200	3,050	3,050	3,050	3,000	14,350
Offsets in Means-Tested Programs and Medicare Premiums	-70	-180	-230	-230	-240	-950
Total	2,150	2,850	2,850	2,850	2,750	13,400

Under current law, the annual cost-of-living adjustment (COLA) for Social Security benefits, paid in January, is generally based on the increase in the Consumer Price Index for urban wage earners and clerical workers (CPI-W) from the third quarter of one year to the third quarter of the next year. If the combined assets of the Social Security retirement and disability trust funds fall below a specified percentage of estimated annual outlays for the program, a "stabilizer" provision in the law takes effect. This provision limits the COLA to the smaller of the increase in either the CPI-W or the annual increase in average wages. Benefit levels would be restored after the condition of the trust funds improved, but no retroactive payments would be made. Under CBO's current economic forecast, the increase in the CPI-W applicable to the January 1989 COLA will be 1.3 percentage points higher than the wage growth over the relevant period. The stabilizer provision is not expected to be used, however, because the ratio of trust fund assets to outlays is projected to remain well above the threshold.

Limiting the Social Security COLA (and the corresponding COLA for the Railroad Retirement Tier I benefit) to the lesser of the increase in wages or prices, regardless of the condition of the trust funds, would save about $2.1 billion in outlays in 1989 and $13.4 billion over the 1989-1993 period. 1/ If arrangements were made for restoring recipients' benefit levels at a later date, long-term savings would be much smaller.

As with other across-the-board COLA restrictions, limiting the growth of benefits in periods when prices are growing faster than wages would achieve substantial savings by spreading the cutback over millions of beneficiaries. In addition, if workers are experiencing reductions in their real wages, one could argue that beneficiaries should experience similar losses.

On the other hand, any reduction in the protection from inflation offered by the current Social Security COLA rules would lessen the standard of living of beneficiaries (and increasingly so as the beneficiary ages). Moreover, some people believe that reductions in Social Security benefits are not needed, since the combined assets of the Social Security retirement and disability trust funds are expected to be sufficient to pay benefits for at least the next half century without any such changes.

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1. Curtailing COLAs could cause some beneficiaries' means-tested benefits to increase and could limit some scheduled premium increases for the Supplementary Medical Insurance part of Medicare, as shown in the table. Reductions in income tax revenues associated with COLA restrictions are not included. Social Security is in budget function 650 and Railroad Retirement is in budget function 600. The means-tested programs are in budget functions 600 (Supplemental Security Income and Food Stamps) and 550 (Medicaid). Medicare is in budget function 570.

ENT-22 RESTRICT COST-OF-LIVING ADJUSTMENTS IN NON-MEANS-TESTED BENEFIT PROGRAMS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Eliminate COLAs for One Year						
Social Security/ Railroad Retirement	7,650	10,500	10,650	10,650	10,450	49,850
Other Non-Means-Tested Programs	1,950	2,700	2,750	2,900	3,000	13,300
Offsets in Means-Tested Programs and Medicare Premiums	-790	-1,350	-1,550	-1,650	-1,700	-7,050
Total	8,800	11,850	11,900	11,900	11,700	56,150
Limit COLAs to Two-Thirds of CPI Increase for Five Years						
Social Security/ Railroad Retirement	2,550	6,350	10,300	14,350	18,550	52,150
Other Non-Means-Tested Programs	660	1,650	2,650	3,700	4,900	13,550
Offsets in Means-Tested Programs and Medicare Premiums	-80	-290	-580	-870	-1,200	-3,000
Total	3,100	7,700	12,400	17,250	22,250	62,700
Limit COLAs to CPI Increase Minus Two Percentage Points for Five Years						
Social Security/ Railroad Retirement	3,400	8,250	13,350	18,700	24,200	67,900
Other Non-Means-Tested Programs	870	2,100	3,400	4,850	6,350	17,550
Offsets in Means-Tested Programs and Medicare Premiums	-110	-380	-750	1-,150	-1,550	-3,900
Total	4,150	9,950	16,050	22,400	29,000	81,600
Pay Full COLA on Benefits Below a Certain Level and 50 Percent of COLA on Benefits Exceeding That Level						
Social Security/ Railroad Retirement	810	2,050	3,300	4,550	5,850	16,550

Outlays for Social Security and other non-means-tested cash transfer programs whose benefits are indexed to the Consumer Price Index (CPI) are expected to total $282 billion this year and to rise to $386 billion by 1993 under current policies. Reducing the automatic cost-of-living adjustment (COLA) for these programs is commonly proposed as an effective way to slow the growth in entitlement spending. Four strategies for reducing COLAs and the savings in outlays resulting from each are shown in the preceding table. 1/ Other options for achieving savings in Social Security are given in ENT-21, ENT-23, and ENT-24.

COLA restrictions would achieve considerable savings by spreading the reduction over a large number of beneficiaries, in contrast to other budget options that would concentrate benefit reductions on smaller groups of recipients. By limiting these options to the non-means-tested cash benefit programs, many of the poorest beneficiaries of entitlements--for example, recipients of Supplemental Security Income--would be protected from losses of income. Significant reductions in outlays would persist beyond the five-year projection period because the benefit levels of those eligible when the COLA limitation was implemented would be permanently lowered. The savings would eventually disappear as beneficiaries died or ceased receiving payments for other reasons, unless the COLA limitation was accompanied by a permanent reduction in the initial benefits of newly eligible workers as well (see ENT-23).

On the other hand, budget reduction strategies that institute less than complete price indexing would result in financial difficulties for some recipients, particularly if they were applied for an extended

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1. The programs whose COLAs would be reduced under the first three options are: Social Security Old-Age, Survivors, and Disability Insurance (OASDI), Railroad Retirement, Civil Service Retirement, Military Retirement, Federal Employees Workers' Compensation, Veterans' Compensation, and retirement benefits for the Foreign Service, the Public Health Service, and the Coast Guard. The fourth option would affect only Social Security and Railroad Retirement Tier I COLAs. Curtailing COLAs could cause some beneficiaries' means-tested benefits to increase and could limit some scheduled premium increases for the Supplementary Medical Insurance part of Medicare, as shown in the table. Reductions in income tax revenues associated with COLA restrictions are not included. OASDI is in budget function 650; Railroad Retirement, Civil Service Retirement, Military Retirement, Federal Employees Workers' Compensation, and retirement benefits for the Foreign Service are in budget function 600; Veterans' Compensation is in budget function 700; retirement benefits for the Public Health Service are in budget function 550; and retirement benefits for the Coast Guard are in budget function 400. The means-tested programs are in budget functions 600 (Supplemental Security Income and Food Stamps) and 550 (Medicaid). Medicare is in budget function 570.

period. Although the exclusion of means-tested benefit programs would limit the impact of COLA reductions for many low-income beneficiaries, numerous others would face substantial declines in their standards of living. COLA reductions also encounter opposition from those who fear that changes made to reduce budget deficits would undermine the entire structure of retirement income policy. Private pension plans generally do not offer complete indexing; COLA restrictions in Social Security would make it more difficult for beneficiaries to protect themselves against inflation. Some people believe that these programs should be altered only gradually and then only for programmatic reasons, because Social Security and other retirement programs represent long-term commitments both to current retirees and to today's workers. Thus, any changes in benefits should be announced well in advance to allow people to adjust their long-run plans.

If COLA limitations were adopted to restrict the growth in benefits for people after they retire, commensurate changes could be made in determining initial benefits for new recipients to avoid introducing disparities in benefit levels among different groups of retirees. This situation is particularly relevant for Social Security, where benefits for those individuals becoming eligible are based on an indexed benefit formula and on indexed earnings histories. For example, if prices rose by 4 percent in a year and the wage index used to compute benefits for newly eligible recipients increased by 5 percent, eliminating that year's COLA without any change in the calculation of initial benefits would result in benefits for new beneficiaries that were about 5 percent higher than for recent retirees; under current law, benefits would be only about 1 percent higher for the new retirees. To mitigate this problem and to achieve additional savings, efforts to slow the growth in benefits through COLA limitations might be extended to the formulas determining initial benefits (see ENT-23).

Several options that would restrict COLAs for current beneficiaries are examined below. The magnitude of the savings in each case--except the option to limit COLAs to two percentage points less than the CPI--is very sensitive to the assumed level of inflation in the years in which the COLAs would be reduced.

Eliminate COLAs for One Year. One option would be to eliminate COLAs in fiscal year 1989 for non-means-tested benefit programs, while allowing them to be paid in subsequent years but with no provision for making up the lost adjustment. If this approach were taken, federal outlays would be reduced by about $8.8 billion in 1989 and $56.1 billion over five years, with Social Security and Railroad Retirement accounting for most of the total. These estimated reductions would be larger or smaller if prices were to rise faster or slower than the 4.5 percent increase currently assumed for the fiscal year 1989 COLA.

Limit COLAs to Two-Thirds of CPI Increase for Five Years. Under this approach, recipients would be compensated for only a certain proportion of inflation, such as two-thirds of the annual CPI increase. Under current CBO economic assumptions, applying this restriction for five years would save about $3.1 billion next year and $62.7 billion over the 1989-1993 period. As a result, benefits for people who received payments throughout the five-year period would be about 7 percent less in 1993 than they would have been under full price indexing. Both cumulative savings and reductions in real income would be greater in an environment of higher inflation and smaller under lower inflation.

Limit COLAs to CPI Increase Minus Two Percentage Points for Five Years. An approach similar to the proportionate COLA reduction would be to reduce the adjustment by a fixed number of percentage points--for example, set the adjustment at the CPI increase less two percentage points. In this case, both savings and effects on beneficiaries would be roughly the same regardless of the level of inflation--about $81.6 billion over the next five years, if extended for the full period. This option would reduce real incomes by about the same percentage every year, regardless of the inflation rate, whereas the two-thirds-of-COLA approach would reduce the purchasing power of benefits most sharply when inflation was high during the five-year period.

Pay Full COLA on Benefits Below a Certain Level and 50 Percent of COLA on Benefits Exceeding That Level. To ensure that lower-income beneficiaries would not be adversely affected by COLA reductions, some analysts have suggested tying the cut to beneficiaries' incomes or payment levels. The example discussed here--based only on Social Security and Railroad Retirement Tier I benefits--would award the full COLA for benefits based on the first $400 of a retiree's Primary Insurance Amount (PIA) and 50 percent of the COLA on benefits above this level; the $400 threshold would also be indexed by the full COLA. This approach would save about $0.8 billion in 1989 and $16.6 billion over the 1989-1993 period. (Another option would be to eliminate COLAs to recipients whose benefits are based on PIAs above a certain level. This COLA reduction would affect the entire benefit of each recipient above the threshold, not just the portion above that level.)

Several concerns are raised regarding this approach. First, benefit levels are not always good indicators of total income. Some families with high benefits have very little other income, while some with low benefits have substantial income from other sources. On the other hand, targeting the COLA restraint on the basis of total income would be administratively complex. Indeed, carrying out the PIA-based option itself would involve considerable effort and would require a longer lead-time than the other COLA options because the Social Security Administration would need to rewrite many computer programs. (The budgetary savings estimates shown above nonetheless are based on implementation in time for the January 1989 COLA.) Second, if this proposal were extended to include other benefit programs, the different benefit structure in each program might require separate determinations of the appropriate benefit levels for paying the reduced COLA. Third, many people object to any changes in retirement programs that might be construed as introducing a means test for benefits, even if the "test" is limited only to the COLA.

ENT-23 REDUCE THE REPLACEMENT RATE WITHIN EACH BRACKET OF THE SOCIAL SECURITY BENEFIT FORMULA

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Outlays	100	390	890	1,400	2,000	4,750

Under current law, the basic Social Security benefit is determined by a progressive formula that provides workers with 90 percent of their Average Indexed Monthly Earnings (AIME) up to the first bend point (which defines the first earnings bracket), plus 32 percent of the AIME in the second bracket, plus 15 percent of the AIME above the second bend point. One method of reducing initial Social Security benefits would be to lower the three replacement rates by a uniform percentage.

Lowering the three rates in the benefit formula from 90, 32, and 15 to 85.5, 30.4, and 14.2, respectively, would achieve an essentially uniform 5 percent reduction in the benefits of newly eligible workers. The reduction in the replacement rates would save about $4.7 billion from Social Security outlays over the 1989-1993 period and more in later years. Under this option, replacement rates for all newly eligible workers would be about 5 percent lower starting in 1989 than they would be under current law. Thus, a 62-year-old retiree who has always earned the average wage would receive initial benefits in 1989 of about 32 percent of pre-retirement earnings, compared with 34 percent if no change is made. This option could be coordinated with a cost-of-living adjustment option (see ENT-21 and ENT-22) to ensure that benefits for both current and future beneficiaries would be reduced to a similar extent, thereby generating substantial budgetary savings, while spreading the impact over a large number of beneficiaries.

Some people contend that it is not necessary to cut initial benefits or make any other reductions beyond those made by the Social Security Amendments of 1983, because the combined assets of the retirement and disability trust funds are expected to be sufficient to pay benefits for at least the next half century. One of the changes made by the 1983 amendments was to increase from 65 to 67 the age at which unreduced Social Security retirement benefits are first available. The change is to be phased in between the years 2000 and 2022. As a consequence, initial benefits for most workers retiring after the turn of the century are likely to decrease anyway, relative to what they would have received had the full retirement age not been increased. For example, a worker who retires at age 62 in 2022 will receive 70 percent of the Primary Insurance Amount rather than 80 percent.

On the other hand, long-term projections of outlays and revenues should be treated with caution because they are enormously sensitive to the assumptions on which they are based. Reductions in initial benefits or other changes in Social Security benefits or taxes could be enacted as a precautionary measure.

ENT-24 ELIMINATE SOCIAL SECURITY BENEFITS FOR CHILDREN OF RETIREES AGES 62-64

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Outlays	40	180	370	610	680	1,900

Unmarried children of retired workers are eligible for Social Security dependents' benefits as long as they are under age 18, or attend elementary or secondary schools and are under age 19, or become disabled before age 22. These benefits help families with children maintain an adequate standard of living after the worker's retirement. A child's benefit is equal to one-half of the parent's basic benefit, subject to a dollar limit on the maximum amount receivable by any one family. If such benefits were eliminated for the children of retirees ages 62 through 64, beginning with retirees reaching age 62 in October 1988, the savings would total about $1.9 billion over the next five years.

This option might encourage some retirees to stay in the labor force longer. At present, though benefits for retired workers and their spouses are actuarially reduced if retirement occurs before age 65, children's benefits are not. Further, the younger the workers are, the more likely they are to have children under age 18. Thus, workers under age 65 now have an incentive to retire while their children are still eligible for benefits. This incentive would be quite small, however, for families in which spouses are also entitled to dependents' benefits, since the maximum family benefit limits the increase in total benefits attributable to eligible children for these households.

On the other hand, for families with workers whose retirement was not voluntary--because of poor health or unemployment, for example--the loss in family income might cause some hardship. Moreover, since spouses under age 62 receive benefits only if their children under age 16 also receive benefits, eliminating children's benefits for families of early retirees would also result in the loss of spouses' entire benefits in some families. In such cases, the total loss of income could be significant.

ENT-25 END CERTAIN VETERANS' COMPENSATION PAYMENTS FOR THOSE WITH LOW-RATED DISABILITIES

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	620	1,450	1,500	1,550	1,600	6,750
Outlays	550	1,450	1,500	1,550	1,600	6,650

Over 2.2 million veterans with service-connected disabilities receive veterans' disability compensation benefits. The amount of compensation is based on a rating of the individual's impairment and an average reduction in the ability to earn wages in civilian occupations. Veterans' disability ratings range from 0 percent to 100 percent and represent differences in functional limitations or severity of the impairment, whereby some veterans may also be categorized as "unemployable" if their rating is 60 percent to 90 percent and they have low earnings; demonstrated loss of income is not, however, an eligibility requirement for people with low disability ratings. Additional allowances are paid to veterans with disabilities rated 30 percent or higher and who have dependent spouses, children, or parents.

Federal outlays could be reduced by about $6.7 billion between 1989 and 1993 by ending cash benefits for those with disability ratings below 30 percent, once benefits have been received for five years, and by ending dependents' allowances for those with ratings below 60 percent. To ease the transition, current recipients who would lose benefits immediately--those who have already received benefits for five or more years or are receiving dependents' allowances--would get one-half of their scheduled benefit or allowance for an additional year. After full implementation, about 1.2 million veterans would lose all their cash benefits (currently between $67 and $133 per month), but they would retain their eligibility for medical care and other associated services. The option would reduce benefits (an average of $48 monthly in 1989) for about 410,000 veterans whose disability ratings are 30 percent, 40 percent, or 50 percent and who have dependents.

This option would target compensation toward the most impaired of the disabled veterans and their families. Allowing only temporary payments for the lowest-rated impairments would bring benefits more in line with workers' compensation programs, which generally provide only two to five years of temporary cash and medical benefits for such disabilities. Since performance on civilian jobs depends less on physical labor than when the cash-payment levels were originally set and because of the availability of and improvements in reconstructive and rehabilitative medicine, veterans with physical impairments rated below 30 percent may not suffer any reductions in their earnings as a result of their low-rated disabilities. Examples of low-rated disabilities include mild arthritis, moderately flat feet, and one partially amputated finger, which may not affect work capabilities in many occupations today. In addition, the continuing increase in households where both spouses work means that dependents' allowances for veterans with disability ratings below 60 percent may not be necessary to maintain adequate family incomes.

Veterans' compensation could be viewed, however, as career or lifetime indemnity payments owed to veterans disabled to any degree while serving in the armed forces. Some disabled veterans losing dependents' allowances might find it difficult to increase their working hours or otherwise make up the loss in payments. A benefit period of less than 10 years might cause concern for some veterans, and a longer phase-out period would give veterans more time to adjust to benefit losses. Moreover, older beneficiaries who have retired from work may rely heavily on their compensation income, so that even a small reduction in payments could have a greater impact on them than on younger veterans.

ENT-26 RAISE THE LOAN FEE FOR VETERANS ADMINISTRATION GUARANTEED HOUSING LOANS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	80	310	270	280	420	1,350
Outlays	80	320	330	350	340	1,400

The Veterans Administration (VA) supports home ownership by veterans through the home loan guaranty program, which allows veterans to obtain mortgage credit from private lenders on more generous terms than usual, such as without a downpayment. In the event of foreclosure, the federal guarantee protects lenders against losses: for home loans of $45,000 or less, the guarantee is worth up to 50 percent of the loan amount; for loans over $45,000, the maximum guarantee is the lesser of 40 percent of the mortgage amount or $36,000, but at least $22,500 for such loans. Under the program, direct loans from the VA also may be available to veterans or non-veterans who purchase foreclosed properties acquired by the VA when veterans default on guaranteed loans. Since 1984, a one-time loan fee equal to 1 percent of the mortgage amount has been required to help defray the program costs. These fees are far below comparable charges for conventional loans, and therefore program participants receive a substantial subsidy. The authority to charge the fee ends after 1989, however. In 1987, net federal outlays for the program were $382 million.

Extending the loan fee and raising it to 1.5 percent would generate enough income to cover the projected net costs of defaults by those paying the fees. If carried out by 1989, this option would reduce federal outlays by about $1.4 billion over the next five years.

Increasing the fees this way would transfer the costs of loan defaults and foreclosures from the federal government to the program's participants. Although participants would pay more, they would still pay less to obtain VA mortgages then they would pay in the conventional private market or for loans insured by the Federal Housing Administration. On the other hand, the increased charges might discourage participation by some low-income home buyers targeted for housing assistance. The option would increase charges for all participants, although most do not default on VA loans.

CHAPTER V

AGRICULTURAL PRICE SUPPORTS AND RELATED PROGRAMS

The near-term outlook for agriculture has improved significantly during the past year. Changes in exports, land prices, commodity stocks, and farm income indicate a recovery of the farm sector, and permit the forecaster to be cautiously optimistic.

These developments are reflected in a decline in federal spending for agriculture, which is expected to continue. Outlays in the price and income support program of the Commodity Credit Corporation (CCC), which account for the bulk of federal spending for agriculture, dropped from a record $25.8 billion in 1986 to $22.3 billion in 1987. Outlays are projected to fall to $17.1 billion in 1988, and to remain close to the 1988 levels in 1989 and 1990.

The improved outlook for agriculture seems to have shifted the focus of policy debate away from major revision of the Food Security Act of 1985, at least for the time being. Federal agricultural spending is still quite high by historical standards, however, and is expected to remain so. The deficit reduction options contained in this chapter describe ways it might be reduced through marginal changes in existing programs.

Savings from the first five options would fall within the Commodity Credit Corporation accounts. The first two options--reducing target prices (AGR-01) and increasing levels of the unpaid acreage reduction requirement (AGR-02)--would adjust the levels of current programs without changing their structure. Reductions in target prices would reduce deficiency payments, the primary direct government payment to farmers. Increasing the requirements for unpaid acreage reduction and, at the same time, reducing paid land diversion, would also reduce direct payments to farmers. The reductions in target prices would affect nearly all participants in price support programs. The change in the acreage reduction requirements would affect only producers of corn and other feed grains.

Savings in the third option (AGR-03) would be achieved by reducing payments to relatively large farms by lowering the payment limit per person and restricting opportunities for individuals to qualify as more than one "person" for payment purposes.

AGR-04 would eliminate generic commodity certificates. The practice of making direct payments to farmers and other CCC program participants in scrip rather than cash has led to profit-making transactions (at federal cost) that some analysts believe was not intended by the Congress. This option would also change the CCC commodity sales price policy to permit cash sales of government grain as a mechanism for the orderly reduction of CCC-held stocks.

Program costs would be reduced in AGR-05 by charging an origination fee for users of CCC's nonrecourse loan programs. Interest rates on these loans are now based on the government's cost of borrowing, which is far below comparable private rates. The origination fee would reduce the level of subsidy of these programs.

The Farmers Home Administration's Agricultural Credit Insurance Fund (ACIF), which makes direct loans and guarantees private-sector loans to farmers, is the second most costly federal support program for agriculture. Outlays were $3.2 billion in 1986, $2.6 billion in 1987, and are projected at $2.1 billion in 1988. Savings could be achieved by reducing direct loans made to farmers (AGR-06). Further savings could be realized by changing practices with respect to property management and collection of delinquencies, and by raising interest rates charged on direct loans (AGR-07).

AGR-01 REDUCE DEFICIENCY PAYMENTS BY LOWERING TARGET PRICES

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	350	1,200	2,050	1,950	2,150	7,700
Outlays	350	1,200	2,050	1,950	2,150	7,700

The Food Security Act of 1985 allows the Secretary of Agriculture to reduce commodity target prices annually beginning with the 1988 crops of wheat and feed grains and the 1987 crops of cotton and rice. The minimum target price for wheat would fall from $4.38 per bushel for the 1986 crop to $4.00 per bushel for the 1990 crop, the final year covered by this legislation. Over the same time period, the target price for corn would drop from $3.03 to $2.75 per bushel, for cotton from $0.81 to $0.729 per pound, and for rice from $11.90 to $10.71 per hundredweight. The Omnibus Budget Reconciliation Act of 1987 reduced target prices for the 1988 and 1989 crops by about 1.5 percent from levels specified in the 1985 act, but did not affect the 1990 crop levels. The following table shows current law minimum target price levels through the 1990 crops, and the CBO baseline assumptions for the 1991, 1992, and 1993 crops. The CBO baseline assumes that target prices would continue to fall after 1990 at the same rate as they were allowed to fall between the 1989 and 1990 crops in the 1985 Food Security Act.

Budget savings could be achieved by reducing target prices faster than allowed in current law. The greater the rate of reduction, the greater would be the savings. One alternative, shown in Table 6, would be to reduce target prices by 5 percent per year starting with the 1989 crops. Outlay savings are estimated to be $7.7 billion over the 1989-1993 period.

A more rapid rate of target price reduction would increase the pace at which farmers begin to respond to market prices, rather than government program benefits, in making production decisions.

U.S. competitors and trading partners would view further target price reductions as more evidence of an intent to reduce the effects of domestic farm policies on world trade in agricultural commodities.

Another argument for further target price reductions is provided by the recent relaxation of acreage reduction requirements. Relatively high acreage reduction requirements during the 1986 and 1987 crop years, together with improved demand, have helped to bring commodity stocks, most of which are owned by the CCC or used as collateral for government loans, under control. Most forecasters expect these stock reductions to lead to smaller acreage reduction requirements in the future. An exception may be corn, in which the

TABLE 6. TARGET PRICES UNDER CBO BASELINE ASSUMPTIONS AND UNDER 5 PERCENT ANNUAL REDUCTIONS (By crop year)

Crop	1988	1989	1990	1991	1992	1993
			CBO Baseline			
Wheat a/	4.23	4.10	4.00	3.85	3.70	3.56
Corn a/	2.93	2.84	2.75	2.63	2.51	2.40
Cotton b/	0.759	0.734	0.729	0.713	0.698	0.683
Rice c/	11.15	10.80	10.71	10.48	10.25	10.02
			5 Percent Annual Reductions			
Wheat a/	4.23	4.02	3.82	3.63	3.45	3.27
Corn a/	2.93	2.78	2.64	2.51	2.39	2.27
Cotton b/	0.759	0.721	0.685	0.651	0.618	0.587
Rice c/	11.15	10.59	10.06	9.56	9.08	8.63

SOURCE: Congressional Budget Office.

a. Dollars per bushel.
b. Dollars per pound.
c. Dollars per hundredweight.

excess stock situation is expected to improve far more gradually than in wheat, cotton, and rice. Relaxing acreage reduction requirements while maintaining relatively high target prices only expands the size of the crop on which this high price protection is provided, and may lead to higher total deficiency payments even while target prices are gradually being reduced.

In part, deficiency payments are compensation to farmers for participating in supply control programs. Reducing acreage reduction requirements without changing target prices increases the rate of compensation. Some proponents of reduced target prices would tie the size of the reduction to the amount of land that must be taken out of production in order to participate in the program.

Lower target prices would reduce farm income by reducing direct government payments. Farm income would not fall by as much as the drop in government outlays because some farmers would choose not to participate in the commodity programs. Though these farmers would give up all of their government payments, they would not be required to idle part of their acreage and would generate income from their additional production.

Despite a general improvement in the economic conditions of farmers and an improved outlook for agricultural markets, many farmers are still facing severe financial difficulties. Opponents of further reductions in target prices would argue that this option would only exacerbate these difficulties. Others, however, would claim that financial assistance targeted directly to needy farmers might be more appropriate and certainly would be more cost effective.

AGR-02 INCREASE REQUIREMENTS FOR UNPAID ACREAGE REDUCTION

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	600	1,000	1,250	1,100	500	4,450
Outlays	600	1,000	1,250	1,100	500	4,450

Participants in current price and income support programs are required to set aside some portion of their land normally planted to program crops in order to be eligible for deficiency payments, nonrecourse loans, and marketing loans. The Secretary of Agriculture's discretion to determine the set-aside requirements is limited by law. The maximum requirement allowed on unpaid acreage reduction is 30 percent in the wheat program, 20 percent in feed grains, 25 percent in cotton, and 35 percent in rice. Increasing the requirements for unpaid acreage reduction when excessive stocks exist would permit reduction in federal outlays. A five-percentage-point increase would result in estimated savings of $4.45 billion over the 1989-1993 period. Savings would be achieved only in the feed grains programs, where unpaid acreage diversion would be substituted for paid land diversion, which is assumed in the CBO baseline. In wheat, cotton, and rice, maximum levels of unpaid acreage reductions are not assumed because current and projected stock levels are not sufficiently large to justify their use.

Increasing unpaid acreage reduction requirements and reducing paid land diversion in the feed grains program would have a relatively small effect on production but would affect farmers' incomes through reduced diversion payments.

AGR-03 RESTRICT PRICE SUPPORT PROGRAM ELIGIBILITY AND REDUCE PAYMENT LIMITATION

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	150	500	460	410	360	1,880
Outlays	150	500	460	410	360	1,880

Current law governing eligibility for price support program benefits, as recently changed in the Omnibus Budget Reconciliation Act of 1987, constrains participants to receive no more than $100,000 in Commodity Credit Corporation (CCC) deficiency payment benefits during any crop year--$50,000 as an individual and $25,000 each as a 50 percent shareholder in a maximum of two corporate entities, each of which is entitled to a maximum payment of $50,000. This maximum can be achieved only by operators of relatively large farms who are actively engaged in the farm operations and who have organized their farm businesses to maximize payments. These recently enacted rules are tighter than those previously in force, which did not effectively limit the number of corporate entities through which program participants could receive benefits.

Government costs could be reduced further by allowing each farm operator to receive payments as only one payment entity rather than a maximum of three. This option would also reduce the maximum direct payment per payment entity from $50,000 to $40,000 per year. The option would not change the types of payments that are subject to the payment limitation and those that are not. An alternative to reducing the $50,000 payment limit would be to broaden the definition of those payments that are subject to the limitation.

Proponents of this change would argue that, even with the newly enacted restrictions, maximum payment levels are too high. If reductions in program spending are required, they should come from relatively large rather than relatively small farming operations.

They argue that reducing the limit on direct payments would reduce the influence that government payments have on large farmers' production decisions and would cause them to be more responsive to market returns. Smaller farmers, who are likely to be more in need of government assistance, would continue to receive program benefits as they do now.

Opponents would argue that this change would harm farm operations of relatively efficient size and that, until operating and price subsidies are reduced for producers in competing countries, increasing the exposure of the most efficient U.S. farmers to market forces would hurt longer-term prospects for the sector.

AGR-04 ELIMINATE GENERIC COMMODITY CERTIFICATES AND ESTABLISH A NEW SALES PRICE POLICY FOR CCC-OWNED STOCKS

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Budget Authority	550	600	250	150	150	1,700
Outlays	550	600	250	150	150	1,700

The Department of Agriculture currently issues generic commodity certificates in lieu of cash for some payments to participants in price and income support, export enhancement, and other programs. These dollar-denominated negotiable certificates can be used by producers to repay outstanding nonrecourse loans, can be exchanged by producers or traders for commodities owned by the Commodity Credit Corporation (CCC), or can be exchanged for cash.

These certificates, and the methods currently used to convert them into quantities of commodities, result in increases in Commodity Credit Corporation outlays that exceed the apparent savings from issuing benefits in certificates rather than cash. One popular use, which clearly causes additional federal outlays, is known as "PIK-and-Roll." In this transaction, a producer places his or her crop under loan at the nonrecourse loan rate and immediately takes it back using generic certificates, with the exchange taking place at the posted county price (PCP), which can be considerably below the nonrecourse loan rate.

For example, a corn producer places 1,000 bushels of a crop under loan with the CCC at the local loan rate of $1.80 per bushel, thus receiving $1,800. If the producer has received a generic PIK certificate with a face value of $1,500 in lieu of a cash deficiency payment of that amount, and the PCP that day is $1.50 per bushel, the certificate can be used to pay off the loan. The producer has transformed a certificate that was received in lieu of $1,500 in cash into $1,800 through this transaction. He or she takes back title to the crop and can sell it at the local market price (which is likely to exceed the PCP), feed it to livestock, or store it for later sale or use. The transaction has cost the government $300 more than if the original deficiency pay-ment had been made in cash.

Eliminating certificates would save $550 million in 1989 and $1.7 billion over the 1989-1993 period. Elimination of the certificates would be at the expense of farmers and other recipients who now profit from their use or their sale to others. However, this profit from the use of certificates was not intended in the Food Security Act of 1985.

Certificates have one important use in price support program operations. Redeeming them for CCC-owned stocks of wheat and feed grains is a way to bring these commodities into the market. These stocks would otherwise be isolated from the market at current prices because under present policy they cannot be sold at prices that are likely to exist in the foreseeable future. Relatively few certificates are now used for CCC stock redemption, since it is more profitable to use them to redeem current loans. In fact, a substantial amount of current CCC lending activity is solely for the purpose of immediately redeeming the loans with certificates. More than 80 percent of the value of certificates issued during fiscal year 1987 was used to redeem nine-month loans.

CCC stocks have reached levels that are unacceptably high. The CCC has recently begun exchanging some of its stock of wheat for certificates by accepting bids, and has taken other actions designed to encourage use of certificates to bring CCC stocks onto the market.

Eliminating certificates and establishing a new sales policy that would allow cash sales of CCC-owned grain by periodic auction, as is currently being done with certificate sales of wheat, would accomplish the goal of reducing CCC stocks while at the same time eliminating the cost of the generic certificate program. An orderly reduction of CCC stocks could take place over the next several years if the Secretary of Agriculture was given the discretion to determine the amounts to be sold. An alternative would be to establish a specific sales price at some level--say 10 percent--above the nonrecourse loan rate and make CCC grain freely available at that price. This latter sales price policy would be similar to that now in place for soybeans, and that was used for grains before the Farmer-Owned Grain Reserve was established.

Proponents of these changes argue that an explicit sales policy would provide the market with a better understanding of how CCC-owned stocks will be marketed. Moreover, making payments in cash rather than certificates would identify some program costs that do not now explicitly appear in the federal budget. For instance, direct costs of the export enhancement program are not evident because the export subsidies are in certificates, which do not now appear in the budget as a government obligation or outlay, though the indirect outlays are captured. Making payments in cash would correct this situation. Finally, substantial government costs caused by certificate redemption of nonrecourse loans, including the PIK-and-Roll transaction, would be eliminated.

Opponents of eliminating certificates would point to a sizable reduction in benefits to participating farmers. Opponents might also argue that making CCC stocks freely available at prices not far from the nonrecourse loan rate would depress prices, dampen price movements, and eliminate some profit opportunities for farmers and traders. Releasing CCC stocks would certainly cause market prices to be lower than if these stocks were permanently removed from the market. However, short of destroying CCC-owned grain, there is no other way of bringing total stocks down to reasonable levels over time.

AGR-05 ESTABLISH A 2 PERCENT ORIGINATION FEE FOR CCC NONRECOURSE LOANS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	240	230	220	220	190	1,100
Outlays	240	230	220	220	190	1,100

Participants in Commodity Credit Corporation (CCC) price and income support programs can receive loans using their crops as collateral. A producer may either repay the loan or forfeit the crop to the CCC at maturity of the loan as full payment. Cash repayment of a wheat, feed grain, or soybean loan includes the loan principal and the interest that has accrued during the term of the loan. Interest rates on CCC loans are based on the government's cost of borrowing, and are lower than would be available for similar types of loans from private sources In the cotton and rice marketing loan programs, the cash repayment required to redeem the loan depends on market prices and can be considerably less than the principal value of the loan. No interest is charged when loans are repaid in these marketing loan programs.

In addition to repaying loans with cash or forfeiting their collateral to the CCC, producers can now redeem commodities under loan by using generic commodity certificates (see AGR-04). No interest is charged when loans are repaid using generic certificates.

Imposing a 2 percent origination fee on nonrecourse loans would recover some of the government's costs from users of the program. Such a relatively small fee would have small effects on market prices, and would save $1.1 billion over the 1989-1993 period.

Opponents of an origination fee argue that a major objective of the nonrecourse loan program is to support the incomes of farmers, and that charging a user fee for participation in an income support program is unreasonable. Moreover, the nonrecourse loan program benefits all producers, even those not participating in government programs, because it supports market prices (except in crops with marketing loans). Charging producers who participate in the loan program while ignoring those who receive the indirect benefits might be considered inequitable.

AGR-06 REDUCE THE DIRECT LENDING AUTHORITY OF THE FARMERS HOME ADMINISTRATION FOR FARM OWNERSHIP AND OPERATING LOANS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	430	320	10	200	110	1,070
Outlays	430	320	280	200	110	1,340

Under current law, the Farmers Home Administration (FmHA) will have authority to make $115 million of direct loans under the Farm Ownership program and $900 million under the Farm Operating program in 1988. CBO projects total direct lending under these programs by the FmHA during the next five years at $5,700 million. In general, the agency uses all of this direct lending authority. Reducing total direct lending authority in these two programs to $625 million per year would result in net savings of $1,340 million over the next five years.

The savings from reducing direct lending authority would be offset to a small extent by increased expenses in the loan guarantee program, since reducing direct lending authority would be expected to increase the demand for loan guarantees. Because more guarantees would be made, the government's contingent liabilities would increase, as would outlays. It is unlikely, however, that guarantees would increase in the same dollar amount that direct lending was reduced. First, not all those receiving direct loans from FmHA would qualify for loans from private lenders, even with the guarantee. Second, private lenders would have at least 10 percent of their own money at risk and would, therefore, share any losses with the FmHA. In general, private lenders would be expected to apply stricter lending standards than does FmHA, with a lower rate of default than experienced in the direct loan programs. Finally, additional expenses in the guarantee program would be spread over time, being incurred only when the guarantee was exercised.

Proponents of this policy stress the budgetary savings and the reduced role of government in allocating credit within agriculture and between agriculture and other sectors.

Those opposed to reducing direct lending authority argue that it would leave the FmHA less able to fulfill its mission of providing financial services for young farmers and those with limited resources. Under the direct loan program, targeted farmers receive subsidized interest rates. In the guarantee program, on the other hand, the terms of the loan are arranged between the borrower and the lender and reflect existing conditions in the credit markets. A smaller program could be maintained, however, in order to satisfy the policy goal of providing credit to a specific group of farmers.

AGR-07 ALTER MANAGEMENT POLICIES AT FARMERS HOME ADMINISTRATION

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Sell More from FmHA's Inventory of Acquired Property						
Budget Authority	300	330	10	0	0	640
Outlays	300	300	0	0	0	600
Collect Delinquent Debt More Aggressively						
Budget Authority	260	680	10	230	110	1,290
Outlays	260	660	260	140	110	1,430
Increase Interest Rates Charged by FmHA						
Budget Authority	0	50	10	80	90	230
Outlays	0	50	70	80	90	290
Savings						
Budget Authority	560	960 a/	10 a/	310	200	2,040
Outlays	560	1,010	230	220	200	2,220

a. Total budget authority savings shown for 1990 and 1991 are equal to projected borrowing authority, not the sum of the savings indicated by the three subparts.

At the end of 1987, the Agricultural Credit Insurance Fund (ACIF) had $0.8 billion of acquired property in inventory and $6.6 billion of delinquent debt ($5.2 billion of which had been delinquent for more than three years). Significant savings could be achieved by changing the manner in which the inventory of acquired property is managed, pursuing more aggressive collection of delinquent debt, and increasing the interest rate charged.

FmHA has not been aggressive in attempting to dispose of its inventory of acquired property--in part because of a restraining order under which it operated during much of 1986, and in part because the agency was reluctant to contribute to the land price decline. It had an estimated 1.6 million acres in inventory at the close of 1987. Currently, farmland values have stabilized in most parts of the country, which should enable the FmHA to be more active in selling acquired property. If, during each of the next five years, FmHA aggressively marketed its inventory and received 75 percent of the estimated average price for land (to allow for quality differences between the FmHA portfolio and agricultural land in general), $600 million in receipts could be generated.

Most analysts see little chance that FmHA can recoup much of the value of the delinquent loans currently on its books. But since many of these loans are generating no income for FmHA, any return it could get from foreclosing on them would be a net benefit. The General Accounting Office estimates that FmHA might get 49 cents on the dollar by foreclosing and selling the underlying collateral. CBO estimates that $1,430 million could be generated in the 1989-1993 period from foreclosing on loans that are now, or are expected to become, delinquent for more than three years.

FmHA lends directly to farmers under regular or limited resource provisions. Interest rates charged for regular operating loans are based on the government's cost of raising funds. The interest rates for limited resource loans are set by FmHA and offer a substantial subsidy. The rate on a limited resource operating loan is currently 6 percent, as compared with 9 percent for a regular operating loan. If interest rates on both limited resource and regular loans were increased by two percentage points, an additional $290 million could be generated over the 1989-1993 period.

The major disadvantage of reducing FmHA's inventory of acquired property would be the depressing impact on agricultural land markets. If delinquent loans were more aggressively pursued, an increase in the number of farm foreclosures could be expected--resulting in additional disruptions to the rural economy and more property for FmHA and other lenders to dispose of. Increasing the interest rate on FmHA loans could lead to more defaults and diminish the agency's ability to provide credit to the most economically disadvantaged members of the farming community.

The proponents of these options would argue that the large inventory of property held by FmHA already has a depressing effect on land prices, and should be reduced as expeditiously as possible. More aggressive pursuit of delinquent borrowers could improve the distribution of resources in agriculture (by making them available to more efficient producers). In addition, less tolerance for delinquencies might improve the overall repayment rate at FmHA. Increasing the interest rates charged by FmHA by two percentage points would still offer qualified borrowers a substantial subsidy relative to commercial rates for farmers in this risk category.

CHAPTER VI

NONDEFENSE DISCRETIONARY SPENDING

Federal activities in the nondefense discretionary (NDD) category include a broad range of programs that generally require annual appropriations. Accounting for just over 16 percent of annual government outlays, these programs encompass national infrastructure development and maintenance, energy development, natural resource management, educational and housing assistance, international aid, and research and development activities.

The 38 deficit reduction options presented here would affect, to varying degrees, all of these major program areas. While the motivations and mechanics of the options vary substantially, reflecting differences in the programs' goals and methods of approach, all of the deficit reduction themes discussed in Chapter II are represented in these reduction options.

The options in this chapter generally are grouped by subject matter. Thus, for example, NDD-04 to NDD-05 address reductions in the level of federal commitment to a national space program, NDD-07 to NDD-11 analyze reductions or changes in federal support and management of energy and natural resource initiatives, NDD-20 to NDD-23 would modify transportation programs, and NDD-26 to NDD-28 focus on alteration in education programs. The other 24 options span the remaining areas of nondefense discretionary spending. As in previous years, no options are presented that rely on federal asset sales, although reforms in federal asset management programs are considered.

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NDD-01 REDUCE THE ECONOMIC SUPPORT FUND

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	150	140	140	130	120	680
Outlays	150	140	140	130	120	680

Budget authority for the Economic Support Fund (ESF) has risen from $2.1 billion in 1981 to $3.2 billion in 1988. The ESF includes both loans and grants to bolster governments deemed politically or militarily strategic. ESF programs often give unconditional budgetary support for a wide range of economic policies, as well as grants to repay outstanding Foreign Military Sales (FMS) credits used to purchase U.S. military equipment. In the 1988 Continuing Resolution, the Congress provided new guarantees and appropriations to refinance these outstanding FMS loans at lower rates. Reducing the ESF by the amount of the refinancing would therefore leave the recipient nations no worse off than they were before the recent Congressional actions. Cutting the ESF by this amount would save $150 million in 1989 and $680 million during the 1989-1993 period.

Proponents of cutting the Economic Support Fund argue that it is dominated by foreign policy and national security objectives rather than by economic considerations; often, the United States ends by subsidizing bad economic policies. Moreover, some argue that the current ESF policies exacerbate distortions created by U.S. emphasis on military spending and by the heavy indebtedness of recipient nations. The provision of such aid may also tend to create client governments that will expect foreign assistance as an entitlement. Furthermore, a large proportion of ESF funds goes to upper-middle-income countries while very little goes to poor countries; for instance, Europe gets more than sub-Saharan Africa. (By contrast, development and humanitarian aid, which help poor countries, have not even kept pace with inflation.) Finally, it is not clear that increases in payments for base rights and for military aid to the Middle East or Central America provide substantial additional security.

On the other hand, the ESF has already been cut (from its $6.16 billion peak in 1985), and its supporters argue that further cuts will only harm U.S. national interests. In 1988, 20 fewer countries will receive ESF than in fiscal year 1987. Nearly two-thirds of the aid goes to Egypt and Israel in support of the Camp David agreements. Much of the remainder goes to Turkey, the Philippines, and other countries where the United States has military bases and where the assistance is used as an increasingly formal payment for base rights. The rest goes primarily to Pakistan and Central America, where the Administration has increased its commitments.

NDD-02 END THE EXPORT-IMPORT BANK DIRECT LOAN PROGRAM

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	110	120	230	480	750	1,690
Outlays	100	230	310	320	320	1,280

The Export-Import Bank (Eximbank) is designed to increase U.S. exports by providing loans and loan guarantees to foreign purchasers of U.S. merchandise. The direct loan program offers subsidized interest rates, while the loan guarantee program encourages commercial banks to lend to foreign buyers by reducing the risk inherent in export financing. While the subsidy element in the direct loan program has been reduced as a result of international negotiations, it still remains substantial. Eliminating the direct loan fund would save $100 million in 1989 and $1.3 billion over the five-year period.

Supporters of the Eximbank direct loan program base their position on three arguments. First, these loans offset subsidies provided by other countries to their exporters. Second, the loans stimulate U.S. exports and hence create jobs. Third, increased exports allow some high-technology industries to maintain high output rates and so achieve economies of scale.

Critics of Eximbank's direct loans consider these justifications overstated. Some of the subsidized exports face little if any subsidized competition--for example, when an exporting company has a monopoly in its submarket (as with the large, long-range passenger jet) or when foreign exporters of similar goods are not subsidized. Also, the evidence suggesting that these subsidies help to increase exports is scarce. Often Eximbank loans merely substitute for conventional commercial financing, producing no net benefit to the nation but transferring income from taxpayers to domestic producers and foreign buyers. Finally, if Eximbank loans serve only to escalate subsidy levels, they may be counterproductive: if other countries retaliate by subsidizing their exports, no country will be better off.

Ending the direct loan program might affect less developed countries and newly industrializing nations disproportionately: the direct loan program is involved with very few loans to Europe or Japan. High-technology and energy-related industries are also overrepresented in direct loan programs. To the extent that Eximbank really creates new demand, rather than substituting for conventional financing, these industries might suffer.

NDD-03 ELIMINATE "CARGO PREFERENCE" AND RELATED SUBSIDIES TO U.S.-FLAG VESSELS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	460	450	450	430	410	2,200
Outlays	460	450	450	430	410	2,200

The federal government provides both direct and indirect subsidies to the U.S.-flag merchant marine--that is, vessels built, owned, and operated by U.S. firms and engaged in international trade. The indirect subsidies arise from "cargo preference" laws that require all U.S. military cargo, 75 percent of U.S. agricultural aid, and one-half of all other government ocean freight to be carried by U.S.-flag vessels. Since the average cost of building and operating U.S. vessels is two to three times that of foreign ships, limiting government shipments to U.S.-flag vessels substantially increases federal shipping costs. Ending "cargo preference" requirements would lower government shipping outlays by over $100 million in 1989 and over $500 million over the 1989-1993 period.

Direct federal subsidies are provided by the operating differential subsidy (ODS) and ocean freight differential subsidy (OFDS) programs. ODS compensates U.S. operators of U.S.-flag vessels in foreign commerce for the difference between the operating costs of a U.S.-flag ship with an American crew and the operating costs of the foreign-flag competition. The OFDS specifically funds the additional cost for the shipment of government agricultural commodities that results from the 75 percent cargo preference requirement for those commodities as against the 50 percent requirement for other nonmilitary shipments. Ending both ODS and OFDS would reduce federal outlays by over $300 million in 1989 and by more than $1.5 billion in 1989-1993.

Proponents of cargo preference legislation argue that subsidizing the nation's shipbuilding and shipping industries maintains the infrastructure needed to construct military vessels during a major war, ensures a standby military sealift capability, and provides a secure supply line for civilian production during wartime. Opponents of cargo preference note that most of the ships benefiting from these subsidies are bulk cargo vessels of limited use to the military. A more cost-effective way to ensure adequate military shipping and shipbuilding capacity would be to purchase directly the kind of ships most useful to the military--liners and roll-on and roll-off vessels--and place those ships in Ready Reserve.

NDD-04 CANCEL THE NASA INTERNATIONAL SPACE STATION PROGRAM

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Savings from CBO Baseline						
Budget Authority	440	460	480	500	520	2,400
Outlays	210	380	440	480	500	2,000
Savings from Administration's Request						
Budget Authority	970	2,150	2,900	3,500	3,700	13,220
Outlays	470	1,400	2,250	3,000	3,450	10,570

The National Aeronautics and Space Administration (NASA) is set to begin construction of an international space station. The facility could cost the United States between $14 billion and $18 billion (in 1984 dollars) in research and development spending, up from NASA's initial estimate of $8 billion, according to the National Research Council (NRC). The permanently manned station is to be operational sometime in the mid-1990s. It will provide infrastructure to support scientific and commercial activity and a departure point for future manned and unmanned exploration of the solar system.

Canceling the current space station program without initiating an alternative could save as much as $2.4 billion in budget authority in the 1989-1993 period, relative to the CBO baseline. The actual costs of proceeding with the space station program would be much greater than the amount in the CBO baseline, however. The Administration's 1989 request would enable the program to move from the planning stages to procurement and construction of the station. Therefore, canceling the space station would save roughly $13 billion in budget authority and $11 billion in outlays relative to the Administration's request over the 1989-1993 period. Because many of the current program's objectives are desirable, an alternative to cancelation would be a more modest program using shuttle spacelab flights, and intermittently tended and unmanned facilities rather than a permanently manned facility.

Advocates of canceling the space station program point out that many of the traditional objectives of U.S. space policy will not be served by the current program. No significant purpose of national security will be served, as the Department of Defense has expressed very limited interest in using the NASA station. Many civilian scientific goals could be met earlier and at a lower cost with a more modest program. Some scientists argue that the space station will absorb funds that would be better spent on space science and exploration, where the known returns are greater. Even though national prestige would be enhanced by having a space station, the current plan would create a permanently manned facility some 10 or more years after the launching of the Soviet space station in 1986. Arguments supporting cancelation of the space station are reinforced by the NRC's estimate that its direct cost will be between $14 billion and $18 billion (in 1984 dollars), together with an additional $6 billion in associated transportation and other costs.

The arguments for the current space station program emphasize its possibilities, both known and unknown, and U.S. commitments to cooperating countries. Manned exploration of the solar system requires the type of long-duration flight provided by the current program. More modest alternatives do not. The prospects for materials research and, ultimately, manufacturing may be sufficient to justify continuing the program at some level. Advocates further contend that other significant uses for a space station will be discovered after it is operational. Moreover, from the perspective of national security and foreign policy, if the United States were to back out of the current program, Europe, Canada, and Japan might be driven to continue the project on their own or perhaps in cooperation with the Soviet Union.

NDD-05 POSTPONE MAJOR NEW SPACECRAFT DEVELOPMENT PROJECTS IN THE NASA SPACE SCIENCE AND APPLICATIONS PROGRAM

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	25	85	140	170	200	620
Outlays	10	45	100	140	180	475

The National Aeronautics and Space Administration's (NASA's) space science and applications program is currently funded at a level of $1.5 billion spread over eight program areas. The physics and astronomy, planetary exploration, and environmental observation programs accounted for 80 percent of this funding in 1987. Each of these three program areas includes development funding to plan for and build new spacecraft, and operations funding to support the flights of existing spacecraft and analyze their data. If no new major spacecraft development was allowed after completing currently funded development projects in the three program areas, NASA could save $475 million over the 1989-1993 period.

Postponing major new starts in any of these areas must be justified on the basis of the overall NASA budget outlook, rather than by program-specific arguments. The scientific knowledge gained by new missions in each area serves a public purpose, but might serve that purpose as well if provided at a later date. In the physics and astronomy area, the launch of two orbiting observatories in the next several years, in addition to existing ground facilities, will provide the interested scientific community with a continuous stream of new data, even if two additional planned observatories, the Advanced X-Ray Astrophysics Facility and the Space Infrared Telescope Facility were postponed for the immediate future. A similar argument can be made for the environmental observation program, where multiple sources of new data will be available regardless of whether or not new spacecraft are developed and launched over the next five years. A principal thrust of the planetary exploration program, the return of samples from other bodies orbiting the sun, would require new missions. But the data flowing from completed missions and those likely to be operating in the near future will provide new information for planetary scientists. Making significant reductions in one or more space science programs, rather than smaller reductions across all space science programs would concentrate resources in the areas that were not cut. This reduction strategy would avoid the consequences of starting and stretching out many projects in many areas, which might mean achieving no near-term results in any particular area.

The cost of postponing new spacecraft development would be incurred both immediately and in the long term. Immediately, U.S. prestige would suffer in the area where new development projects were forgone, and other countries would gain in the prestige accompanying this type of space science. Moreover, the cuts might discourage the entry of new scientific and engineering talent into the fields affected by the cuts, creating a long-term lag. These negative effects would be mitigated to the extent that the areas in which NASA chose to focus could benefit and advance more rapidly.

NDD-06 CANCEL OR DEFER THE SUPERCONDUCTING SUPER COLLIDER

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Savings from CBO Baseline						
Budget Authority	25	25	30	30	30	140
Outlays	20	25	30	30	30	135
Savings from Administration's Request						
Budget Authority	360	680	480	450	490	2,460
Outlays	230	520	510	480	480	2,220

The Administration has proposed undertaking the next-generation high-energy particle accelerator, the Superconducting Super Collider (SSC), at a total estimated cost of $5.3 billion. At present, the Congress has not authorized construction of the SSC, although it has provided some funding for design R&D. Consequently, canceling the SSC, either permanently or until an international consortium could be formed to pay for it, would save only $135 million in outlays relative to the CBO baseline. It would, however, save $2.2 billion relative to the President's request during the 1989-1993 period.

Opponents of the SSC have put forward several reasons why the SSC should be deferred, canceled, or radically altered. First, the project is very big, both to build and to operate. The SSC, together with the NASA space station, would absorb much of the growth in the science function of the budget. Some opponents fear that these two projects would cannibalize other science programs, resulting in fewer research projects. Even when built, the SSC is projected to cost $270 million a year to operate, over one-third of current Department of Energy (DOE) general science outlays, when DOE is already having trouble funding all its accelerators. Second, as the recent advances in superconductivity have clearly demonstrated, "small science" has a great deal to offer both practically and theoretically. The return to society, both in knowledge and in practical uses, may very well be greater from funding many small projects rather than a few large ones. Third, there may be less ambitious alternative designs that would still advance high-energy physics. Finally, the cost of the SSC could be shared internationally; the Europeans, the Japanese, and the Soviets have large-scale accelerator programs under way, and coordinating accelerator efforts with one or more of these programs could lower the costs substantially.

Proponents of the SSC argue that the next generation of high-energy physics experiments will require energy levels of magnitudes only the SSC can provide. Less ambitious programs, such as those being undertaken in Europe, may not be able to provide the energy levels needed to investigate particle phenomena assumed to exist at this higher level. Furthermore, without newer experimental facilities, U.S. research programs might not be able to attract the brightest young physicists and would fall behind the European Community in particle physics. On the other hand, the Congress may very well be reluctant to fund rapid development of ever larger particle accelerators without consideration of their cost.

NDD-07 REDUCE SUBSIDIES PROVIDED BY THE RURAL ELECTRIFICATION ADMINISTRATION

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	950	1,000	1,100	1,150	1,150	5,350
Outlays	100	330	520	680	820	2,450

The Rural Electrification Administration (REA) is an agency within the Department of Agriculture that provides financial assistance to rural electric and telephone cooperatives. In 1973, the Congress set up the Rural Electrification and Telephone Revolving Fund (RETRF) to provide direct loans to rural utility cooperatives at an interest rate of 5 percent, and authorized the REA to fully guarantee loans made to cooperatives by other lenders. In 1987, the REA provided $867 million in direct loans and $175 million in loan guarantees. When the RETRF was created, the 5 percent rate on REA direct loans was about one percentage point below the then-prevailing long-term Treasury borrowing rate. Since then, however, the gap between the 5 percent rate paid by the cooperatives and the interest rate that the REA pays to finance the direct loans has widened considerably. Although this interest rate differential has decreased since its widest margin of ten percentage points in 1984, the gap still remains at almost five percentage points today.

Because the fund's expenses have consistently exceeded its loan repayment receipts, it must borrow from the Federal Financing Bank (FFB) at a rate equal to the long-term Treasury rate plus one-eighth of 1 percent. The Treasury rate peaked at over 16 percent in 1984, and is projected at 9.6 percent in 1988, well above the 5 percent rate the REA charges. Mainly because of the interest rate subsidy provided to REA borrowers over the years, the federal government incurs large budgetary costs associated with REA lending activities each year. Budgetary savings could result from lower levels of REA lending, set by the Congress, and an increase in the interest rate on REA direct loans.

Lowering REA lending levels would enable substantial federal budgetary savings. If the Congress reduced the requirements for new REA direct and guaranteed loans to 50 percent of 1988 loan levels of $861 million and $933 million, respectively, REA budget outlays would fall by about $100 million in 1989, and by about $2.2 billion over the 1989-1993 period. If the REA targeted its direct loans toward those cooperatives most in need of federal financial assistance, the effect of reducing REA's lending levels would likely be small and could be more equitable.

Raising the interest rate for REA's direct loans to equal the Treasury rate would not generate significant additional income for the fund during the next decade because the gap between current Treasury interest rates and the REA 5 percent interest charge is small. A higher rate would, however, strengthen the financial soundness of the revolving fund, making it less dependent on additional borrowing from the FFB in the future. Taken together, increasing REA's interest rate to equal the Treasury rate and decreasing the levels of REA loan obligations by about 50 percent would reduce REA program outlays by about $2.5 billion over the 1989-1993 period.

Opponents of maintaining REA subsidies at their current level point out that the REA has largely fulfilled its original goal of making electric and telephone service available in rural communities. Proponents of the current REA program would argue, however, that many cooperatives still depend on the low-interest loans to expand and maintain viable electric services to rural communities. They claim that increasing the interest charges or reducing the amount of REA loans provided to these cooperatives would raise the utility bills of their customers, particularly affecting the more rural, less densely populated regions. Raising the REA interest rate would have little effect on most cooperatives' rates, however, as interest charges account for only a small percentage of the average ratepayer's bill. Furthermore, reducing the level of the REA's direct loan program could decrease federal subsidies to the financially sound cooperatives while still providing federal financing to cooperatives that truly need it.

NDD-08 REFORM DEBT REPAYMENT POLICY FOR POWER MARKETING ADMINISTRATIONS

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Budget Authority	140	130	140	140	140	690
Outlays	230	250	260	230	250	1,220

Federal power marketing administrations (PMAs)--including the Alaska Power Administration, the Bonneville Power Administration, the Southeastern Power Administration, the Southwestern Power Administration, and the Western Area Power Administration--sell electricity at wholesale rates from hydroelectric generating plants owned and operated by the federal government. Capital investments for these dams and power and irrigation facilities are financed by federally appropriated funds, which must be repaid at interest rates ranging from zero to 16 percent, averaging about 3 percent. Currently, the outstanding debt obligations of these agencies to the federal government total about $13.7 billion.

By law, the PMAs must use income from electricity sales to cover all operating costs, and repay all federal investments within a "reasonable period," nominally 50 years, though not at a set rate or on a fixed timetable. Department of Energy policies currently allow the PMAs to determine their own schedules for repaying the principal portion of their outstanding debt. In some cases, the principal payments on the federal loans are being deferred until the end of asset lives. Since only interest costs are being paid on these loans, for which the Treasury is not receiving any regular repayments on the loan principal, the amount of deferred loan repayments increases the federal budget deficit.

Requiring the PMAs to repay all federal appropriations on fixed amortization schedules over project lifetimes would increase Treasury revenues and thus lower federal outlays by $230 million in 1989 and about $1.2 billion over the 1989-1993 period. (Such receipts enter the budget as offsets to outlays.) The resulting increase in principal repayments could increase electricity rates for wholesale customers in certain service areas.

Though the PMAs have promoted regional industrial bases by providing electricity to undeveloped areas, critics contend that the prices they charge for electricity do not reflect the actual cost of delivering power. They point out that the original development goal has been met, and that the below-market rates and unregulated repayment schedules represent an inequitable subsidy to certain regions--a cost borne by all taxpayers. Finally, they argue that requiring the power agencies to repay their federal debt obligations on amortized schedules would not disrupt local economic activity, since electricity prices in areas served by the power agencies would still remain below the national average. Proponents of the status quo counter that enforcing a strict debt repayment schedule could translate into higher product prices and lower market shares in some industries--for example, the aluminum industry in the Pacific Northwest.

NDD-09 CHANGE REVENUE-SHARING FORMULA FROM A GROSS TO A NET RECEIPT BASIS FOR COMMERCIAL ACTIVITIES ON FEDERAL LANDS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	240	260	260	260	260	1,280
Outlays	220	260	260	260	260	1,260

The federal government owns 700 million acres of public lands--about one-third of total U.S. land. These public lands contain a rich supply of renewable and nonrenewable natural resources, such as timber, grazing land, oil and natural gas, coal, and many minerals. Private entities are allowed access to much of this land to develop the resources found there, and generally pay fees to the federal government based on the commercial returns from this activity. In many cases, the federal government allots a percentage of these receipts to the states and counties in which the resources are found, as compensation for lost tax revenues from the federal lands in their boundaries. It does this on a gross receipts basis before taking account of the federal government's program costs. But providing federal receipts-sharing on a gross rather than a net basis encourages overutilization of national resources and, in some cases, results in federal program costs that exceed the government's share of receipts.

The U.S. Forest Service provides 25 percent of its gross receipts from commercial activities in the national forests--including timber sales, grazing fees, and receipts from mining of "common variety" materials such as sand, gravel, limestone, and cement--to the representative states and localities. The Bureau of Land Management provides 4 percent of its timber receipts, about 12.5 percent of its grazing fees, 4 percent of its mining fees from common variety materials, and 50 percent of its onshore oil, gas, and other mineral receipts to the states. (On certain federal lands called the Oregon and California grant lands, gross federal receipts from all commercial activities, primarily timber sales, are shared with the states and counties on a 50-50 basis.)

Federal savings would be substantial if these agencies deducted their program costs from their gross receipts before making payments to states. The regional jurisdictions would continue to receive the same allotted percentage of net federal receipts--roughly $700 million in 1989. Certain federal costs would increase, however, under the federal Payment in Lieu of Taxes (PILT) program, established in 1976 to offset the effects of nontaxable federal lands on local governments' budgets. These PILT payments to the states are partially reduced by the amount of the revenue-sharing payments from federal agencies. Costs to the federal government under the PILT program would increase, therefore, if the option to share net rather than gross receipts was implemented. These costs have been netted out of the projected savings. Changing the revenue-sharing formula from a gross receipt basis to the more economically efficient net receipt basis would reduce net federal outlays by $1.3 billion over the 1989-1993 period.

Deducting costs from federal receipts for commercial activities on public lands before making payments to local governments would probably reduce uneconomic commercial uses on these lands. On the other hand, many local areas that depend on the federal programs associated with these activities for jobs and federal revenue-- particularly the federal timber sales programs--might be hurt economically. To help mitigate this hardship, the federal agencies could switch to the net receipt basis over a period of several years and promote other uses of the public lands in these areas, such as tourism and recreation.

NDD-10 IMPROVE PRICING FOR COMMERCIAL USES OF PUBLIC LANDS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Hardrock Mining Claims						
Budget Authority	0	75	75	75	75	300
Outlays	0	75	75	75	75	300
Grazing Fees						
Budget Authority	30	30	30	30	30	150
Outlays	30	30	30	30	30	150
Below-Cost Timber Sales from National Forests						
Budget Authority	30	40	60	60	60	250
Outlays	30	40	60	60	60	250
Federal Water Sales						
Budget Authority	15	15	15	20	20	85
Outlays	15	15	15	20	20	85

The federal government owns and manages over 727 million acres of land in the United States. Many of these lands have a wide range of multiple uses, including mining, grazing, and lumbering among other commercial applications. For most commercial uses, the government receives compensation in the form of fees, royalties, and bonuses. Increasingly, it is argued that several of these compensation schemes fail to provide a fair return to the government and that underpricing may have led to overuse. Better pricing could increase federal receipts and limit commercial activity to more economically justified levels.

Hardrock Mining Claims

Private access to public domain lands for hardrock mining (for example, mining of gold, copper, and molybdenum) is controlled by the Bureau of Land Management (BLM). Under the Mining Law of 1872, with the discovery of a "valuable mineral deposit" and the staking of a mining claim, a prospector has the right to mine and sell public domain minerals without paying fees or royalties to the federal government. The only condition is an annual expenditure of $100--a "diligence requirement"--to develop the claim. Moreover, under current patenting provisions, public hardrock mining lands are allowed to pass into private hands for a nominal fee of $2.50 to $5.00 an acre and, it is argued, without a thorough assessment of the alternative uses these lands may have.

The current mining law could be amended to change the current diligence requirement from its 1872 level of $100 to a yearly fee of $1,000 (roughly the equivalent of $100 in 1872) paid directly to the U.S. Treasury beginning two years after a claim is staked. The patenting provision could also be revoked to prevent a rush of patent applications, although this change might raise certain legal questions. These amendments would free public lands of inactive claims, and would raise an estimated $75 million annually beginning in 1990, partially compensating the federal government for the value of the minerals extracted and the cost of reclaiming abandoned sites

Some opponents argue that any change in the current law that reduced the prospector's expected return would significantly decrease overall prospecting, including prospecting for strategic minerals that are important for national security. While a $1,000 yearly fee would probably reduce prospecting and possibly some current mining, these effects might be somewhat offset by the clearing of inactive claims and the opening up of land formally closed to hardrock mining for fear of the patenting provision. As an alternative, production royalties have also been proposed as a way for the government to extract a fair share of the rents from mining on federal land. A royalty system would be administratively expensive, however, since the BLM would have to estimate ore content and processing costs at each of the approximately 150,000 active claims.

Grazing Fees

The Forest Service (FS) and the Bureau of Land Management administer livestock grazing on approximately 307 million acres of public rangelands. These lands can provide ranchers with over 21 million animal unit months (AUM) of grazing each year. A recent study has estimated the market value of forage in six western regions at between $5.20 and $9.50 per AUM. The BLM and FS spend, on average, $2.44 per AUM to manage these rangelands. In contrast, the fee formula established by the Congress has set permit fees of $1.35 per AUM for the last three years, representing a large subsidy for a relatively small group of ranchers. Fifty percent of these fees currently go into the Range Betterment Fund. On March 1, 1988 the grazing fee will be increased to $1.54 per AUM. The increase reflects changes in the indexes of costs of production, cattle prices, and land lease rates.

The present fee formula could be adjusted by changing its base from the 1966 appraised forage value to the 1983 regional appraised values of private grazing lands. This would increase the base from $1.23 to an average of $6.68 and raise $30 million in additional receipts in 1989 and $150 million over the 1989-1993 period. In estimating these savings, deposits to the Range Betterment Fund were capped at $30 million a year, roughly three times the current funding level. This cap reflects an estimate of how much the fund could spend, at least over the next several years.

Opponents of increased fees argue that comparing private with public lands may overstate the value of public lands to the extent that they are in worse condition or have less favorable lease terms. In addition, they state that low fees may encourage permit holders to invest in range improvements and to practice good stewardship over the land by grazing only at the permitted levels. Increased fees, they argue, would cut ranchers' profit margins, and encourage them to break the grazing limits and forgo range improvements. But ranchers currently spend on average only $0.16 per AUM for range improvements. Increased funding from the Range Betterment Fund would offset any decrease in private range improvements. Providing ranchers with longer-term leasing agreements might make it in their interest to minimize overgrazing, regardless of the fee level.

As an alternative to administratively set fees, grazing rights could be allocated through a competitive bidding process similar to the system used by the Bureau of Indian Affairs. The main disadvantages to this approach may be high administrative costs and limited competition since in many cases only the owners of private lands adjacent to federal lease tracts would be willing to bid for grazing rights (current law requires permit holders to own a base property adjacent to the federal lease tracts).

Below-Cost Timber Sales from the National Forests

The Forest Service within the Department of Agriculture manages federal timber sales from 119 national forests in the National Forest System. Roughly 12.7 billion board feet of public timber sold under contract to private lumber companies was harvested in 1987 (or about 15 percent of total U.S timber production), providing about $800 million in federal timber receipts. The FS spent approximately $600 million on timber management, reforestation, timber road construction, and other timber program costs, resulting in net federal timber receipts of $200 million.

In three of the nine National Forest System regions, however, annual cash receipts from federal timber sales consistently have not covered annual cash expenditures of the FS in that region. These so-called "below-cost" timber sale regions include the Rocky Mountain Region, the Northeastern Region, and the Intermountain Region. On average, over the past decade, cash expenditures in these regions have exceeded cash receipts by a ratio of three to one. (Annual timber program costs in these regions still exceed annual timber receipts even if FS expenditures for timber road construction are excluded.) The FS does not maintain the data to estimate the annual timber receipts and expenditures associated with individual timber sales; thus, it is hard to determine precisely the budgetary savings that could be achieved by phasing out all below-cost timber sales in the National Forest System. As an illustration of the potential savings, however, eliminating all future timber sales from the three regions mentioned above would reduce FS outlays by about $40 million to $110 million, including savings in the timber road budget. Timber receipts would be reduced by about $10 million to $50 million. Net savings in federal budget outlays over the 1989-1993 period would be about $250 million.

Proponents of reducing below-cost timber sales argue that they not only add to the federal deficit, but lead to the overdepletion of federal timber resources through uneconomic timber harvests, to the economically unwarranted destruction of roadless forests valued by many recreational visitors, and to government interference with private timber markets.

Opponents of such cuts argue that the FS timber program generates other benefits besides receipts to the federal government. Among these, it provides community stability to areas dependent on the federal timber industry for logging and other jobs relating to timber products. But the risk of economic hardship from eliminating the federal timber program in these areas could be reduced by gradually lowering the level of below-cost timber sales, providing federal job replacement skill programs, and encouraging greater development of other local industries such as tourism and recreational activities in the national forests.

Federal Water Sales

The Bureau of Reclamation (BOR) provides water resources from federal water projects for western industrial and agricultural uses, as well as supplying municipal water systems. This water is made available through long-term contracts with water district commissions composed of individual users. The prices for water charged under these contracts are generally substantially lower than the economic value of the water; for many agricultural users, they rarely cover the federal costs associated with the water projects.

In recent years, the Congress has considered several reforms aimed at reducing the subsidy to agricultural users of federal water and at increasing receipts to the federal government. Some proponents of the reforms have argued that the BOR should at least charge full cost for federal water used to produce agricultural commodities, such as rice, that are subject to price-support programs. An additional reform would require that farms of more than 960 acres be charged full cost for federal irrigation water. (Current law does contain this requirement but is vague concerning the definition of a "farm" and is therefore often circumvented. BOR is required, however, to investigate possible abuses of the acreage limitation rule.) While these two reforms would only address a portion of the federal subsidy to water users, they are illustrative of the changes in the current system that could increase federal receipts from water sales. Taken together, the two proposals could lead to increased receipts of $85 million over the 1989-1993 period.

NDD-11 INCREASE AND EXPAND FEES CHARGED FOR RECREATIONAL USE OF NATIONAL PARK SERVICE AND OTHER PUBLIC LANDS

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Budget Authority	110	120	120	130	140	620
Outlays	110	120	120	130	140	620

All of the major federal land management agencies allow some level of recreational use of the public lands under their control. For example, in 1987, total operating outlays for the National Park Service were $648 million. Offsetting receipts, in the form of entrance or recreational user fees, however, accounted for only $36 million. The scope and type of recreational services for which fees are charged could be expanded, or the level of currently charged fees could be increased to reflect more accurately the direct costs of providing recreational visitor services. Increasing recreational fees on National Park Service lands, for example, to cover direct costs could reduce federal costs $110 million in 1989 and $620 million over five years.

The agencies managing federally owned lands provide a wide range of recreational, commercial, and research services. Virtually every land management agency offers some level of recreational use on some portions of the public lands under its control. The recreational services may range from rough hiking trails to fully developed campsites, marinas, and the like. Some of the agencies charge user or entrance fees, but these cover only a small portion of overall costs. For example, the National Park Service incurred direct visitor costs of approximately 44 cents per visit in 1987 compared with fee receipts of around 10 cents per visit. Requiring federal land management agencies to design their fee collection policies to cover the direct costs of providing recreational services would shift the burden of those costs to the beneficiaries of the service and result in improved pricing of the nation's public lands.

A policy of pricing recreational services at direct cost would probably require the agencies to expand the number of facilities on which fees are charged and to increase the level of fees currently charged. A number of factors--including multiple access points or too few visitors--limit the economic and technical feasibility of charging fees for every federally operated or maintained recreational service. On the other hand, agencies are often legislatively constrained from charging fees. The National Park Service is limited by law in the amounts it may charge, and fees are prohibited at some parks. Among those at which fees are prohibited is the national park with the highest number of visitors, the Great Smoky Mountain National Park. Some prohibitions against fees are based on legal barriers (such as deed restrictions) but others reflect Congressional concern with various social goals. Such concerns might be effectively handled through targeted programs. The objection that increased recreational user fees would discourage access and use by the poor or the elderly (for example, in urban national parks) could be mitigated by offering free access days or cross-subsidizing from other park fees. It might also be argued that current recreational users should not be assessed the full cost of maintaining resources that are also of value to nonusers. This argument would be less relevant if fees were limited to the variable costs of recreational use.

NDD-12 INCREASE THE HARBOR MAINTENANCE TAX

	Annual Added Revenues (In millions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Addition to CBO Baseline a/	200	300	300	300	400	1,400

a. Estimates are net of reduced income and payroll tax revenues.

The Army Corps of Engineers now spends about $500 million per year to maintain channel depths for more than 180 ports nationwide. In 1988 the government will recover about 30 percent of these expenses through a tax on the value of commercial cargo loaded or unloaded at ports not part of the Inland Waterway System. Raising the Harbor Maintenance Tax from 0.04 percent to 0.12 percent of the cargo's value would lower the deficit by $0.2 billion in 1989 and by $1.4 billion over the five-year period from 1989 through 1993.

Two arguments have been made in favor of raising the Harbor Maintenance Tax. First, the Corps' dredging activities provide a commercial service to an identifiable set of beneficiaries: shippers save money both through the lower unit costs of shipping on larger vessels and by being able to minimize inland transport costs. Second, the tax would have little effect on economic activity, for the tax would increase average port-use charges (which include, among other things, wharfage, dockage, and stevedoring) by less than 1 percent.

Opponents of this option note that, because the tax is the same at all ports, a higher tax would increase the extent to which the more efficient, low-cost ports (where operations and maintenance now cost less than one cent per ton of cargo handled) would be subsidizing the less efficient, high-cost ports (where O&M costs are hundreds of dollars per ton of cargo).

NDD-13 ELIMINATE FEDERAL GRANTS TO STATE REVOLVING FUNDS FOR WASTEWATER TREATMENT PLANT CONSTRUCTION

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	1,200	1,300	2,600	2,700	2,800	10,600
Outlays	75	360	670	1,200	1,700	4,050

The Environmental Protection Agency now offers local governments grants that cover 55 percent of the construction costs for wastewater treatment plants needed to meet the requirements of the Clean Water Act (CWA) Amendments of 1972. Budget authority for these construction grants is set at $1.2 billion for 1989 and 1990, at which time they would expire.

The 1987 CWA Amendments required that the construction grants program be replaced by a temporary "capitalization grants" program. Capitalization grants would provide federal funds to state revolving loan funds (SRFs). For each dollar in federal capitalization grants, a state would have to contribute 20 cents to its SRF. States would be required to use SRF monies primarily to provide localities with low-interest loans to pay for the construction of wastewater treatment facilities. Budget authority for the capitalization grants program is set at $1.2 billion for 1989 and 1990, $2.4 billion for 1991, $1.8 billion for 1992, $1.2 billion for 1993, and $0.6 billion for 1994, after which the program would end. Eliminating the capitalization grants program would reduce federal outlays by $75 million in 1989 and by $4.1 billion over the 1989-1993 period.

Proponents of such cuts note that, since their inception, federal wastewater treatment grants were intended to be temporary. Proponents argue that ending these grants sooner than is called for by current law would have little effect on water pollution, for the grants have done little to stimulate aggregate wastewater treatment outlays, and, in some cases, have encouraged inefficient decisions by state and local governments. In particular:

- Studies indicate that state and local governments reduce their own wastewater treatment expenditures between 40 cents and 70 cents for every dollar that they receive from the federal government. Most of the federal grants thus have substituted for state and local spending, and not supplemented it.

- The availability of federal grants has prompted some communities to wait until federal assistance was available (sometimes they have waited more than 10 years), rather than promptly correcting known pollution problems--thus delaying compliance with the Clean Water Act.

- Providing grants for construction, but not for operation and maintenance, has reduced incentives for localities to find less capital-intensive, and less costly, alternatives for controlling water pollution.

Arguments against such cuts are threefold. First, states and localities would find it more difficult to meet the CWA wastewater treatment deadlines without the funding levels called for by current law. Second, the capitalization grants might be more efficient than the construction grants, for states will have some ability to tailor the terms of loans from their SRFs to the particular circumstances of each recipient. Finally, the capitalization grants would create a permanent fund to assist with future wastewater control efforts at the state and local level; eliminating that fund would increase the financial burden that states and localities will face in coping with future water pollution problems.

NDD-14 REDUCE FEDERAL SUPPORT FOR AGRICULTURAL RESEARCH AND EXTENSION ACTIVITIES

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	310	330	340	360	370	1,710
Outlays	240	310	340	350	370	1,610

The Department of Agriculture's Agricultural Research Service (ARS) and Cooperative State Research Service (CSRS) conduct and support agricultural research. ARS is the in-house research arm of the department, operating at locations throughout the country. CSRS provides support for research conducted at land-grant universities and other eligible state institutions. The Extension Service (ES) educates farmers and other rural residents in farming methods and conducts a nutrition education program aimed at low-income families throughout the country. The 1988 appropriation for these agencies totaled $1.2 billion. Reducing funding levels by 25 percent would save $1.6 billion over the 1989-1993 period.

Proponents of reducing support for these activities believe that federal research often works at cross-purposes with other federal policy goals. Some argue that money spent on research aimed at increasing productivity in these times of substantial excess capacity could be better spent elsewhere. Furthermore, some research directly benefits groups that should either conduct it themselves or share in its cost. Others argue that government research may result in larger, more capital-intensive farms rather than maintaining family-sized farming operations.

Advocates of reducing activities of the Extension Service cite the relatively large portion of the ES budget that does not benefit farmers. The President's 1988 budget contained a proposal to eliminate most ES activities other than those directly aimed at assisting active farmers. Proposed for elimination were the Expanded Food and Nutrition Education Program and funds aimed at specific activities including urban gardening, pest management, farm safety, and rural development.

Opponents point to the importance of both research and extension in the development of an efficient agricultural sector. They cite the benefits to consumers and the need to maintain the competitive position of U.S. farmers in world markets.

NDD-15 INCLUDE FOREIGN DEPOSITS OF U.S. BANKS IN THE FDIC INSURANCE BASE

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Budget Authority	--	--	--	--	--	--
Outlays	290	290	300	300	310	1,490

Under current law, the Federal Deposit Insurance Corporation (FDIC) annually assesses insured banks at the rate of one-twelfth of 1 percent on a bank's average domestic deposit liability, less certain exclusions and deductions. The FDIC, in turn, insures these deposits against default, up to $100,000 per account. Deposits at foreign branches of insured banks are neither covered by the insurance nor charged premiums. Such foreign deposits amount to about 15 percent to 20 percent of total bank deposits. This proposal would amend current law to include deposits at foreign branches of insured banks, with respect to both insurance and premiums.

Proponents of this proposal argue that extending insurance coverage to foreign deposits of U.S. banks would make explicit a policy that now implies coverage of those deposits free of cost to the banks holding them. This implied coverage was stated by the Comptroller of the Currency, among others, who in the wake of the Continental Illinois Bank rescue said that the government would not allow big banks to fail. Big banks hold over 80 percent of the foreign deposits of U.S. banks. Proponents also point out that big banks now pay a lower insurance premium on their total deposits (much of which are held in foreign branches) than do smaller banks, which rely exclusively on domestic deposits, thus giving big banks a competitive advantage. Opponents take the view that insuring such deposits would raise the exposure of the FDIC to a prohibitive level, since it would add new potential liabilities rather than simply recognize existing implied coverage. They also argue that increased premiums would reduce the overseas competitiveness of U.S. banks by increasing their costs.

The additional income that the FDIC would receive from assessments on these deposits is uncertain. The effective premium rate paid by insured banks may vary from year to year depending primarily on the rate of insured bank failures, which can affect allowed refunds. Also, deposits in foreign branches of U.S. banks have varied considerably over the past decade. Assuming, however, that foreign deposits grew at a rate comparable to that of recent years, and that this proposal would maintain the current statutory premium and be implemented before January 1, 1989, FDIC collections under the proposal would increase by about $290 million in fiscal year 1989. Beyond that, increased assessments could provide additional annual income to the FDIC of approximately $300 million through 1993, depending on the rate of growth of foreign deposits. In budgetary terms, these additional collections would reduce FDIC outlays in each year. The potential liability base could increase by over $350 billion (the approximate size of foreign deposits). Because the FDIC operates through a trust fund that is self-financed and has a surplus cash balance, there would be no immediate effect on budget authority.

NDD-16 DISCONTINUE POSTAL SUBSIDIES FOR NOT-FOR-PROFIT ORGANIZATIONS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	420	430	450	470	490	2,260
Outlays	420	430	450	470	490	2,260

The Postal Reorganization Act of 1970, which replaced the old Post Office Department with the independent U.S. Postal Service, intended that the mail system operate as a largely self-sufficient enterprise with mail users paying the full costs of postal services. But certain bulk mailers--notably religious, educational, and other charitable organizations and state and national political committees--receive favored statutory treatment. These favored mailers pay reduced postage rates that, on average, cover only about 70 percent of the cost of services received. The taxpayer subsidizes the remaining cost through annual federal payments made by the Congress, referred to as revenue forgone appropriations. In 1988, the revenue forgone payment for not-for-profit bulk mailers totals some $400 million. Almost $2.3 billion could be saved through 1993 if such payments were discontinued and the subsidized postage rates, effective October 1988, were increased accordingly. Subsidies supporting reduced rates for blind and otherwise handicapped persons, libraries, and others could be continued. (Option FWF-04 would raise costs for all mailers by eliminating the indirect retirement subsidy given the Postal Service.)

Increasing rates for preferred mailers would further the goal of requiring mail users to pay for the cost of services they receive. Proponents of eliminating the subsidy argue that allowing special rates for favored mailers encourages overuse of mail services. This overuse causes households, especially those with higher incomes, to receive more mail than they may want; the Philanthropic Advisory Service, a branch of the Better Business Bureau that monitors the activities of charitable organizations, reports frequent complaints from citizens who have received multiple solicitations for support from the same not-for-profit groups. Further, the Advisory Service has found that, for some not-for-profit organizations, fund-raising costs consume a very high percentage of the contributions received from those campaigns. (The President's 1989 budget would also cut revenue forgone appropriations, but takes another approach to the preferred mailers' subsidized rates. Instead of ending preferred rates as current law requires if appropriations are discontinued, the Administration would keep them and, after 1989, shift their cost to other mailers through higher stamp prices.)

While acknowledging that discontinuing special rates could cause financial problems for some groups, critics of the subsidy argue that the federal government can no longer afford to support the mailing costs of groups already receiving substantial federal assistance. They point out that not-for-profit organizations received about $4.0 billion in federal grants in 1987 and that in the same year support in the form of tax deductions for charitable contributions cost the government, through lower tax revenues, an estimated $15.6 billion. Moreover, subsidized postage represents an additional burden on taxpayers who, before taxes, contributed more than $70 billion to charitable organizations in 1986.

Opponents of this alternative argue that the subsidy promotes the flow of educational, cultural, charitable, and similar information. (Originally, it also reflected an effort to ease the transition from the old, heavily subsidized post office system to the new self-supporting Postal Service.) Eliminating postage subsidies would also, critics of this option caution, cause rates for not-for-profit organizations to increase by up to 50 percent. (If the Congress reduces appropriations below required levels, the Postal Service is required to increase postage rates paid by favored mailers.) Such rate hikes could pose financial difficulties for some organizations, especially those that depend heavily on mail solicitation for fund raising and those just starting out.

NDD-17 SCALE BACK THE RURAL HOUSING LOAN PROGRAM

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Reduce New Lending						
Budget Authority	640	640	630	-35	-45	1,800
Outlays	440	610	620	620	610	2,900
Increase Borrowers' Payments: Increase Interest Rate						
Budget Authority	75	150	210	170	260	870
Outlays	75	150	210	280	330	1,050
Increase Borrowers' Payments: Increase Percent of Income						
Budget Authority	35	70	110	90	140	440
Outlays	35	70	110	150	190	550

The Section 502 housing program, administered by the Farmers Home Administration (FmHA), provides mortgages to enable low-income borrowers to purchase homes by spending only 20 percent of their incomes on mortgage payments, property taxes, and insurance. The FmHA's major cost is the difference between the rates it pays for the funds it borrows to finance the program and the rates borrowers pay for FmHA mortgages--which can be as low as 1 percent. During 1987, more than 24,000 rural households in the continental United States with incomes averaging $13,700 purchased single-family homes with loans at reduced interest rates from the FmHA. Two broad approaches for reducing the costs of this program are described here.

Reduce New Lending. If new lending under the Section 502 program was halved, the number of new households that would receive the deep subsidies now provided to a small proportion of all eligible households would be reduced, and federal outlays would be about $440 million lower in 1989 and $2.9 billion lower over the 1989-1993 period. Making such sizable payments to so few households may not be the best use of scarce federal resources. On the other hand, under this option, fewer low-income rural households would become homeowners.

Increase Borrowers' Payments. The second major approach to scaling back the rural housing loan program would be to continue lending at the present volume but raise the costs to new borrowers, either by increasing the interest rates on mortgage loans or by increasing the percentage of income paid toward the loans.

If new borrowers paid the FmHA's borrowing rate--currently about 9.6 percent--for Section 502 loans, the cost of this program would be reduced by $75 million in 1989 and $1.05 billion over the 1989-1993 period. Alternatively, if new FmHA borrowers paid 28 percent of their incomes for housing costs, federal outlays would be cut by $35 million in 1989 and $550 million in the 1989-1993 period.

An advantage of charging the market rate of interest on these loans is that it would make the cost of homeownership for all borrowers in rural areas--those served by the Section 502 program and those with loans made by private financial institutions--more nearly equal. The second option would eliminate a disparity between the FmHA Section 502 program for rural homeowners and a comparable program sponsored by the Department of Housing and Urban Development in which urban borrowers pay 28 percent of their incomes for housing costs.

On the other hand, increasing the mortgage interest rate or increasing the percentage of income that rural households would pay toward housing costs would shift the composition of borrowers away from households with the very lowest incomes. In addition, having higher housing costs relative to income might lead to higher default rates among new program participants, although historically default rates have averaged only about 2.5 percent.

NDD-18 IMPOSE A ONE-YEAR MORATORIUM ON NEW FUNDING FOR RURAL RENTAL HOUSING ASSISTANCE

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	700	-10	-10	20	25	720
Outlays	35	310	160	80	5	580

The Section 515 housing program, administered by the Farmers Home Administration (FmHA), provides low-interest 50-year mortgages to developers of multifamily rental projects in rural areas. The mortgages have interest credits that reduce their effective interest rates to 1 percent. These reduced-rate mortgages in turn lower rental costs for Section 515 tenants, who are a small proportion of all the households in rural areas eligible for rental housing assistance. Under current rules, assisted tenants contribute toward their housing expenses the greater of 30 percent of their adjusted incomes or the minimum project rent, which includes the costs of amortizing the 1 percent mortgage plus the project's operating expenses. The developer keeps the minimum rent, and the FmHA collects any payments above this minimum and treats them as additional interest payments to reduce the program's cost. During 1987, about $555 million in new Section 515 loans were made, sufficient to finance about 17,000 new rental units.

A one-year halt in the funding of construction of new projects would reduce federal outlays by about $35 million in 1989 and $580 million in the 1989-1993 period, precluding the provision of rental units for about 17,000 households. This moratorium would eliminate for one year the deep subsidies currently provided to developers of rural rental projects and their tenants. (The average annual subsidy for newly assisted households under the Section 515 program exceeds $4,000.) The advantage of this option is that this sizable payment would be made to fewer tenants who are, in fact, no different from other eligible people who are not helped. On the other hand, halting new funding even for a year would probably lessen the supply of standard-quality low-income rental projects in rural areas.

NDD-19 IMPROVE PRICING OF THE ELECTROMAGNETIC SPECTRUM

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	0	0	0	0	0	0
Outlays	-250	-250	0	0	0	-500

The Federal Communications Commission (FCC) has the responsibility of allocating the electromagnetic or radio spectrum in accord with the public interest. Current FCC policy does not require private parties to pay for the right to exploit the spectrum (beyond an application fee) for any of its uses, including traditional radio and television broadcasting as well as new commercial areas such as cable television, satellite and microwave communications, and cellular telephone and paging services. Auctioning unassigned portions of the radio spectrum could generate $500 million over the 1989-1993 period, and would lead to improved pricing of this public resource.

Until 1982, the FCC allocated the spectrum through a comparative administrative hearing process that weighed the relative merits of the contending applicants. In 1982, in response to criticisms that the hearing process was too long and too costly for the government and for society as a whole, the Congress permitted the FCC to experiment with the assignment of portions of the spectrum by lottery to all participants capable of meeting minimum eligibility criteria. Currently, the lottery process has been suspended so the FCC can reevaluate the process.

Proponents of the auction mechanism argue that substituting an auction for the lottery and hearing methods of spectrum allocation would increase the efficiency of the process and benefit the economy as a whole. The auction mechanism would provide a fair market-value measure of the unassigned spectrum, and thus encourage its economically efficient use. According to proponents, an auction mechanism would also decrease the cost to the government of spectrum allocation and allow private-sector resources devoted to the application process to be more profitably applied elsewhere. As auction proposals do not include changes in licensee requirements, the FCC role of guarding the public interest would not be compromised. A spectrum auction was proposed in a 1985 amendment to the Communications Act and in the President's 1988 budget. The Administration's proposal would exclude mass media, amateur, and public safety frequencies from the auction process.

The principal argument of opponents is that an auction system would preclude small, less wealthy applicants--for example, local telephone cooperatives--from expanding their use of the spectrum. The financial strength of large firms is already a determining factor in the hearing process (given regulatory and legal expense), and also in the lottery process (given the secondary market for spectrum allocation created by that method of assignment). Opponents also argue that, as a revenue source, the auction system would not provide a stable, continuous inflow, since no additional spectrum beyond the current quantity is available for use. Some future revenues could be expected, however, if technological change creates profitable uses for currently unused higher-energy parts of the spectrum. Finally, public-sector users such as police, fire, and other emergency providers have expressed concerns that an auction, with its revenue-raising potential, could eventually decrease the proportion of the spectrum allocated to the public sector.

Two alternative pricing proposals relating to the electromagnetic spectrum would be a 2 percent asset transfer tax on the sale of spectrum rights, and an excise tax on the sale of equipment receiving signals transmitted over the spectrum. The transfer tax could raise about $1.0 billion over the next five years. Unlike the auction option, the transfer tax would be likely to impede the movement of spectrum assets from lower-value to higher-value uses, and thus fail to produce an efficient distribution of capital within the industry. A tax on the sale of spectrum receivers could be levied at a rate that would produce levels of revenue similar to those of the media transfer tax. But the imposition of such a tax could not be supported by the same argument raised in support of the auction or the transfer tax--that of being imposed on the use of a public resource for private profit. A variation on all of these revenue-raising options would direct the proceeds to a trust fund supporting public broadcasting.

NDD-20 REDUCE FEDERAL MASS TRANSIT AID

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	750	790	850	890	940	4,200
Outlays	35	190	380	520	670	1,800

In the last 15 years, the federal government has assumed a major role in financing local mass transit systems. In 1985, federal capital grants accounted for 65 percent of all mass transit investment. The federal matching rate on local capital expenditures now ranges between 75 percent and 85 percent; limiting the federal share to 50 percent and reducing federal appropriations commensurately would produce savings of $35 million in 1989 and $1.8 billion over the 1989-1993 period.

Proponents of a lower federal matching rate argue that the current rate encourages localities to adopt structural, capital-intensive solutions to mass transit problems when a less capital-intensive, even nonstructural, approach would do--for example, using buses and/or carpool lanes instead of building a subway. Further, they note that estimated costs exceeded estimated benefits on over half of the new mass transit systems approved by the Congress for grants in 1988. A higher local cost share would help to reduce the number of such uneconomic projects in the future.

Supporters of the higher matching rate argue that mass transit aid is an important part of the federal strategy to combat urban ills. Mass transit fosters local economic development and can relieve urban congestion (even though the existing federal program may not be the most cost-effective means to these ends). Further, mass transit can improve the mobility of disadvantaged groups such as the poor, the elderly, and the disabled.

NDD-21 REDUCE BOTH THE FEDERAL SHARE OF HIGHWAY EXPENDITURES AND THE OBLIGATION CEILING ON THE HIGHWAY FUND

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Budget Authority	1,000	1,000	1,000	740	520	4,300
Outlays	170	680	850	850	700	3,250

The federal government now pays 90 percent of the construction and rehabilitation cost of the highways and bridges that are part of the Interstate Highway System. Federal expenditures are financed by the Highway Trust Fund. Fund income is derived from motor vehicle fuel taxes and interest paid by the U.S. Treasury on the cash balance in the fund. Under current policies, budget authority is expected to exceed fund income in each of the next five years, but obligation ceilings are expected to keep outlays roughly equal to the fund's income during this period. Lowering the federal matching rate to 70 percent (and reducing the obligation ceiling commensurately) would decrease outlays by $170 million in 1989 and $3.3 billion over the 1989-1993 period.

Proponents of a lower federal share argue that, on average, states' benefits from current highway projects would exceed their costs, even if the state share of costs were higher than under current law. Further, a higher state cost share would give states greater incentive to screen out the minority of projects that are not cost effective.

Opponents note first that lowering the federal matching rate would increase the financial burden on states and localities. Second, this option would increase the surplus in the Highway Trust Fund, for outlays would be reduced while revenues from the gas tax would remain unchanged. If that surplus eventually was spent, the savings from this option would prove transitory.

NDD-22 ELIMINATE THE AIRPORT GRANTS-IN-AID PROGRAM

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	1,700	1,700	1,800	1,800	1,850	8,850
Outlays	200	730	1,050	1,200	1,350	4,530

Annual federal spending for the nation's airport and air traffic control systems exceeds annual federal revenue from aviation excise taxes. This spending includes outlays for facilities and equipment and the operation of the air traffic control system, and grants for capital improvements at the nation's airports. Eliminating the airport grants-in-aid program would save $4.5 billion over the five-year period and would bring expenditures for nonfederal use of the airway system more in line with income from aviation taxes.

Aviation taxes are paid into the Airport and Airway Trust Fund and include a tax on domestic passenger tickets, an international departure tax, aviation fuel taxes paid by general aviation, and a waybill tax on air cargo shipments. Trust fund spending for aviation programs is supplemented each year by the general fund. In 1987, tax revenue to the trust fund was $3.2 billion, spending from the trust fund was $2.6 billion, and general fund spending for aviation was $2.3 billion. The surplus that currently exists in the trust fund is a direct result of these general fund expenditures for aviation programs over the last decade. Without this general fund subsidy, aviation tax receipts would be insufficient to cover current spending.

Proponents of eliminating this program argue that users of the airway system, not general taxpayers, should fund the air traffic control system; therefore, all of the Federal Aviation Administration's costs attributable to nonfederal use of the airway system should be paid from aviation tax revenues. Since annual aviation tax income is insufficient to cover the operating and capital costs of the airway system while also funding grants to individual airports, some would argue that airport grants should be eliminated. In their view, airport grants have a lower priority from a national interest standpoint than the airway system. Further, most commercial airports have little trouble financing capital improvements through the sale of bonds, and could likely raise additional funds equal to their current federal grants in the bond market. An alternative option would be to reduce the airport grant program to the level of funds available each year after the airway system costs have been covered.

Supporters of the airport grant program argue that the nation as a whole benefits from the system of airports, and that the system will be more efficient if federal funding is continued along with local support of capital spending. Rather than eliminate airport grants, they would rather raise aviation taxes to cover all airway and airport spending, or continue to have the general fund subsidize the operating costs of the airway system.

NDD-23 RAISE CHARGES TO COVER TRANSPORTATION SAFETY PROGRAMS

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Federal Safety Services						
Total						
Budget Authority	600	620	650	680	710	3,250
Outlays	540	610	640	670	700	3,150
Federal Aviation Administration						
Budget Authority	290	300	310	330	340	1,550
Outlays	290	300	310	330	340	1,550
Federal Railroad Administration						
Budget Authority	30	30	30	35	35	160
Outlays	25	30	30	35	35	150
Coast Guard						
Budget Authority	280	290	300	320	330	1,500
Outlays	230	280	300	310	330	1,450
Safety Research, Regulation, and General Investigations						
Total						
Budget Authority	150	160	170	170	180	830
Outlays	140	160	160	170	180	800
National Aeronautics and Space Administration						
Budget Authority	35	35	35	40	40	190
Outlays	20	30	35	40	40	160
National Transportation Safety Board						
Budget Authority	25	25	30	30	30	140
Outlays	25	25	30	30	30	140
Department of Transportation						
Budget Authority	100	110	110	120	120	560
Outlays	100	110	110	120	120	550
All Safety Programs						
Total						
Budget Authority	750	780	820	850	890	4,100
Outlays	680	770	810	840	880	3,970

In 1988, federal agencies will spend $1.1 billion on research into transportation safety issues and on regulation, inspection, or enforcement of transportation safety standards. Around $100 million of this will be spent on programs of general or national benefit, including an arbitrary half of NASA aeronautical research that may also contribute to safety in space and defense programs. Around $350 million comes from three trust funds--for Highways, Airports and Airways, and Aquatic Resources. The remaining $650 million, covering spending in all modes, is financed by annual appropriations. Raising taxes on transportation users, imposing new charges, and in some cases delegating authority for safety services would save $4 billion over five years.

The benefits of safety programs accrue directly to vehicle manufacturers, transportation firms, and users of transportation services, but the extent of federal cost differs both by mode and by area. Well over 90 percent of safety spending for highway and pipeline users is paid from user fees, and users pay for nearly one-third of aviation safety programs; but only around a tenth of the programs for boaters is paid from industry taxes. Motor vehicle operators pay for most nonemergency rescue and towing, but the Coast Guard provides free tows to the 40 percent of boaters in federal waters; automobile owners and trucking companies pay for roadworthiness inspections of their vehicles, but federal inspectors provide free service for railroads, ports, and aviation firms. Raising charges to cover the cost of federal safety services would eliminate the subsidy paid by general taxpayers under present funding, as well as the unequal treatment of users.

Charges to cover safety programs could be set by increasing user fees that now cover part of the federal cost, or by imposing new taxes to recover new spending authority in other programs. Two types of safety programs exist. In the first type, where a federal service is performed, a fee for the work might be appropriate. Service fees could be set for: Federal Aviation Administration airworthiness certification of new aircraft; safety inspections of airports, and pilot and mechanic licensing; Federal Railroad Administration safety inspections of railroads, and Coast Guard inspections of ports; and nonemergency rescue in federal waters. Such fees could recover the $540 million federal cost of these services. Service fees might also encourage properly qualified firms to offer inspection and rescue services that meet federal standards, thereby allowing private services to substitute for some federal activities. The second type of safety program covers federally financed research and regulation on safety issues by the Department of Transportation; aeronautical research by the National Aeronautics and Space Administration in fields of controls and guidance, flight systems, and human factors; and the operations of the National Transportation Safety Board. Costs of these programs could be assigned to beneficiaries in a number of ways, including, possibly, an increase in transportation fuel taxes (see REV-23).

On the other hand, the amounts required to develop and enforce safety standards are not closely linked to the use of transportation services; they are often determined by engineering or other complex technical issues. Thus, fees based on the cost of services provided by federal agencies might be set too high and inhibit innovation of safe designs for new transportation systems. Moreover, agencies might find it difficult to set fair service fees if no comparable private provider was available. Tying spending for safety too closely to levels of industry taxation could result in underfinancing if new major efforts were called for, and might encourage transportation firms to request fewer inspections rather than pay fees for federal inspections.

NDD-24 END FUNDING OF THE ECONOMIC DEVELOPMENT ADMINISTRATION AND OF URBAN DEVELOPMENT ACTION GRANTS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Terminate EDA						
Budget Authority	220	220	230	240	250	1,150
Outlays	40	110	170	220	240	770
Terminate UDAG						
Budget Authority	220	230	240	250	260	1,200
Outlays	0	45	100	160	240	550

The Economic Development Administration (EDA) provides grants to state and local governments for public works, technical assistance, and job programs, as well as loan guarantees and direct loans to firms for business development. In 1988, appropriations for EDA programs totaled about $207 million. The Department of Housing and Urban Development administers the Urban Development Action Grant (UDAG) program, which received $216 million in appropriations in 1988 for distribution to local governments through a competitive selection process to help them finance economic revitalization projects. Federal spending for local economic development could be reduced by $40 million in 1989 and $1.3 billion over the 1989-1993 period by disbanding the EDA and eliminating the UDAG program as of 1989.

Some critics of these programs contend that federal assistance should not be provided for activities whose benefits are primarily local and which, therefore, should be the responsibility of state and local governments. In addition, both programs have been criticized for allowing federal dollars to be used for projects that would have been supported anyway, for not directing funds to the most distressed areas, for substituting public for private credit, and for facilitating relocation of businesses from one distressed area to another through competition among communities for federal funds. In particular, EDA has been criticized for its broad eligibility criteria, which allow areas containing 80 percent of the U.S. population to qualify for benefits, and for providing aid with little proven effect at great expense compared with other programs having similar goals. While the UDAG program has more stringent eligibility standards, and more evidence exists that its completed projects are meeting investment and employment expectations, grants are often provided for projects in vital commercial centers where full conventional financing may have been available. Furthermore, because of the competitive nature of both programs, local governments do not incorporate this type of aid into their budget plans; hence, eliminating future funding of EDA and the UDAG program would not impose unexpected hardships on communities.

On the other hand, the reduction in aid associated with this option would curtail economic development activities in some financially distressed communities that might not be able to tap other resources. This could result in deterioration of infrastructure, loss of prospective jobs, and decreases in local tax receipts. Eliminating these two sources of funds might have especially serious consequences for the most distressed communities, particularly in view of overall federal cutbacks in urban aid programs.

NDD-25 ELIMINATE OR RESTRICT COMMUNITY DEVELOPMENT BLOCK GRANTS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Terminate CDBG						
Budget Authority	3,000	3,100	3,250	3,400	3,500	16,250
Outlays	120	1,350	2,650	3,150	3,300	10,550
Restrict Eligibility and Reduce Funding						
Budget Authority	410	430	440	460	480	2,250
Outlays	15	190	360	430	450	1,450

The Community Development Block Grant (CDBG) program provides annual grants, by formula, to metropolitan cities and urban counties under its entitlement component. The program also allocates funds to each state, by formula, for distribution through a competitive process among nonentitlement areas, which are generally units of local government under 50,000 in population that are not metropolitan cities or part of an urban county. The grants may be used for a wide range of community development activities, including rehabilitation of housing, improvement of infrastructure, and economic development.

For 1988, appropriations for the CDBG program amount to $2.9 billion, of which about $2.0 billion is allocated to metropolitan cities and urban counties and nearly $0.9 billion to nonentitlement government units. Substantial federal savings could be realized either by terminating the CDBG program or by restricting eligibility for the entitlement component to exclude the least needy communities while reducing funding levels.

Terminate CDBG. If the CDBG program was eliminated, federal outlay savings would amount to $120 million in 1989 and a total of $10.6 billion over the 1989-1993 period. This change would result in federal funds being targeted more toward programs that offer national benefits rather than to programs like CDBG that generate primarily local benefits, which--according to some critics--should be funded by state and local governments. Moreover, to the extent that localities use CDBG funds to compete against each other to attract business, benefits have been shifted away from localities to private firms.

A disadvantage of terminating the CDBG program would be that many activities financed by the program are not now generally undertaken by local governments--particularly the rehabilitation of low-income housing and, to some extent, economic development. Thus, eliminating this funding--the largest source of federal aid for many cities--would probably curtail these types of activities in many areas and, in general, reduce resources benefiting low-income households. Furthermore, CDBG funding has presumably been figured into the budgets of entitlement recipients so that ending that support could impose at least temporary stress on many governments, particularly in view of cutbacks in other federal assistance programs.

Restrict Eligibility and Reduce Funding for Entitlement Component. If the entitlement component was cut 20 percent by eliminating funding for the least needy communities, federal outlays could be reduced by $15 million in 1989 and $1.5 billion over the 1989-1993 period. Such a cutback would change the distribution between the entitlement and nonentitlement components from 70 percent/30 percent to 65 percent/35 percent. The entitlement component of the CDBG program now provides aid regardless of need, although jurisdictions with scarce resources receive larger grants than other communities. It might be argued that no pressing interest is served by supporting jurisdictions that have above-average ability to fund projects themselves. Eliminating funding for such communities rather than reducing grants across the board would ensure that the most distressed jurisdictions would retain the same level of aid.

On the other hand, CDBG funds in general must be used to aid low- and moderate-income households, to eliminate slums and blight, or to meet emergency needs. Thus, a reduction in federal funds for affluent communities would probably curtail such activities in pockets of poverty in those areas.

NDD-26 ELIMINATE UNTARGETED FUNDING FOR ELEMENTARY AND SECONDARY EDUCATION

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Eliminate Chapter 2 Block Grant						
Budget Authority	530	570	600	620	640	2,960
Outlays	65	430	560	590	620	2,260
Eliminate Untargeted Portion of Vocational Education						
Budget Authority	430	440	460	480	500	2,310
Outlays	50	340	430	460	480	1,770
Eliminate Mathematics and Science Education Program						
Budget Authority	120	130	140	150	150	700
Outlays	15	100	130	140	150	530

Most federal aid for elementary and secondary education is targeted toward students with special needs. Compensatory education (Chapter 1) funds, for example, are intended for low-achieving children in schools with many poor children. (Chapter 1 is part of the Education Consolidation and Improvement Act, or ECIA.) Federal funds also are provided to help educate handicapped children.

Substantial amounts of money, however, are spent on programs that have no federal requirement for targeting funds toward students with special needs. Examples are the Chapter 2 block grant (of the ECIA), the portion of vocational education grants not targeted toward specific groups of students, and the mathematics and science education program. Ending funding for these three areas would reduce budget authority by about $1.1 billion in 1989--$530 million from the block grant, $430 million from the untargeted portion of vocational education, and $120 million from the mathematics and science program. Outlays would be reduced by $130 million in 1989 and almost $4.6 billion over the 1989-1993 period.

These changes would save substantial amounts of federal money while leaving intact federal aid specifically directed to students and school districts most in need of that assistance. The effect on total spending for elementary and secondary education would also be small, because the reductions would constitute substantially less than 1 percent of total state, local, and federal expenditures. Moreover, since at least some of these grants support activities that districts would undertake even without the grants, eliminating these funds would have a smaller effect on the specific activities ostensibly funded by them than the size of the grants might suggest.

On the other hand, this reduction could pose hardships for some jurisdictions, because it would come at a time of increasing enrollments. Moreover, these programs have purposes other than increasing services to students with special needs. For example, Chapter 2 block grant funds are intended to provide districts with relatively unrestricted funds for program innovations and improvements, and one goal of the program innovation portion of the vocational education program is to help districts alter their training programs as the skills needed for employment change. Terminating federal funds would require districts to rely on state and local resources for these purposes; to the extent that the grants lead jurisdictions to provide services that they otherwise would not, these goals would be less well met.

NDD-27 REDUCE FEDERAL FUNDING FOR CAMPUS-BASED STUDENT AID

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	250	260	270	280	290	1,330
Outlays	25	240	260	270	280	1,070

The federal government provides campus-based student aid through three programs: Work-Study, Perkins Loans (formerly National Direct Student Loans), and Supplemental Educational Opportunity Grants. Financial aid administrators at colleges and universities determine which eligible students receive aid. In fiscal year 1988, the federal government provided $1.2 billion of campus-based aid, serving an estimated 1.5 million students. Reducing federal funding for these programs by 20 percent would lower budget authority by $1.3 billion and outlays by $1.1 billion during the 1989-1993 period.

This option could be implemented by simply cutting federal appropriations, or by combining the cut with a restructuring of the campus-based programs. The number and types of students affected would depend on how the cuts were structured and on how institutions and financial aid administrators reacted to the changes. Some institutions would continue their own student aid at existing funding levels, thereby reducing the overall financial aid available for students; other institutions might increase their own aid to offset part or all of the reductions in federal support.

Combining reduced funding with a restructuring of the campus-based programs could mitigate the effects of less aid. For example, because this aid is not heavily targeted on low-income students, the Congress might choose to restrict eligibility for it to more needy students. On the other hand, such restrictions would reduce institutional discretion to adjust for students' special circumstances. A second option would consolidate the three campus-based programs into one block grant, thereby increasing administrators' discretion in allocating funds. Such an increase in discretion would probably not offset fully the effects of reduced funding, however, and could mean that federal goals were less well met. A third alternative would require institutions to provide a larger match of their own funds for each dollar received from the federal government. If institutions provided the increased match by raising their own support for student aid, federal spending could be cut while maintaining the amount of assistance available to students. To the extent that institutions did not offset the reduction in federal spending, however, less student assistance would be available.

NDD-28 REDUCE PELL GRANT FUNDING AND INCREASE TARGETING

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	220	230	240	250	260	1,200
Outlays	45	220	230	240	250	990

The Pell Grant program, which provides grants to undergraduate students, is the federal student aid program most focused on low-income students. Reducing federal funding for Pell Grants by 5 percent would lower federal outlays by almost $1 billion during the 1989-1993 period.

Funding appropriated for fiscal year 1987 will support grants for an estimated 2.9 million students during the 1987-1988 school year. Grants will range between $200 and $2,100, averaging an estimated $1,300 per student. About 45 percent of this aid will go to dependent students--virtually all to students from families with incomes below $30,000, and two-thirds to students from families with incomes below $15,000. Students who are financially independent of their parents will receive the other 55 percent. After fiscal year 1987, however, Pell Grants will be somewhat less targeted on the needy because the Higher Education Amendments of 1986 have expanded eligibility.

This option could be implemented by simply cutting federal appropriations and using reduction formulas available under current law, or the cut could be combined with changes in the rules determining Pell Grant eligibility and awards. The number and types of students affected would depend on how the cuts were structured and on how institutions reacted to the reductions. If the program rules were not changed and the appropriation was reduced, the Secretary of Education could lower students' awards so that the estimated cost of the program would equal the appropriation. Although the Secretary has some discretion on the particular formula used to reduce grants, the grants of the neediest recipients are protected by law. Alternatively, the Congress could change the eligibility rules while still protecting awards for needier students by, for example, eliminating small grants, eliminating the income offset for state and local taxes, and increasing the proportion of income that families would be expected to contribute to educational costs.

Changes such as these would probably not have a large impact on students' enrollment decisions because they would protect the grants of more needy students. In addition, some colleges and universities would increase their support for student aid, thereby partially offsetting reductions in federal funding.

On the other hand, the students who would lose aid under this option would generally have lower family incomes than many students who now receive other types of federal aid and who would continue to receive such aid if the other student aid programs were left unchanged. Furthermore, because some colleges and universities would not increase their current levels of student aid, less aid would be available to students.

NDD-29 REDUCE FUNDING FOR ARTS AND HUMANITIES

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Budget Authority	170	180	180	190	200	910
Outlays	120	170	180	190	200	850

The federal government subsidizes various arts and humanities activities. In fiscal year 1988, federal funding for the Corporation for Public Broadcasting, the Smithsonian Institution, the National Gallery of Art, the National Endowment for the Arts, and the National Endowment for the Humanities totaled $800 million. Reducing funding for these programs by 20 percent would lower federal outlays by $120 million in 1989 and by $850 million in the 1989-1993 period.

This option could result in little reduction in arts and humanities activities, if other funding sources--states, private individuals, firms, and foundations, for example--increased their own support. Requiring matching grants from organizations receiving federal aid or increasing the required nonfederal match could offset some of the reduction in federal spending. In addition, since many of these programs benefit higher-income persons more than those with lower incomes, increased payments such as admission fees could substitute for some federal aid.

On the other hand, simply reducing appropriations would probably mean that fewer arts and humanities projects would be undertaken because other funding sources would not be likely to offset fully the loss in federal aid. In addition, this option would be implemented at the same time that major changes are occurring in the federal personal and corporate income tax systems. These changes could lower charitable giving and thus reduce nonfederal funding for the arts and humanities.

NDD-30 REDUCE FUNDING FOR RESEARCH SUPPORTED BY THE NATIONAL INSTITUTES OF HEALTH

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	350	360	380	390	410	1,880
Outlays	130	310	360	380	400	1,570

The federal government will spend about $5.9 billion for health research funded through the National Institutes of Health (NIH) in 1988. About 70 percent of the NIH research budget is awarded to universities and hospitals through research grants, contracts, and centers. The remainder is spent on research within the institutes and for administration. If funds for NIH research were reduced by 5 percent, the 1989-1993 outlay savings would total about $1.6 billion.

The NIH could reduce research spending in several ways--for example, by reducing the number of grants awarded. Since funding of projects is based on a rating system, proposals with the highest ratings would continue to be supported. The NIH could also limit the overhead costs of research grants, which might have only limited effects on the amount of research actually undertaken. Alternatively, research projects could be funded at 95 percent of cost, thereby encouraging researchers to find additional sources of support for their work.

Advocates of a reduction believe that NIH spending is excessive. They point to its rapid growth--about 66 percent between 1983 and 1988, or 47 percent after allowing for inflation. They also note that operational overhead is consuming a large and growing proportion of NIH's total funding for grants, averaging about 30 percent in 1988.

Opponents of a reduction maintain that cuts would have adverse effects on the country's biomedical research. They contend that some researchers who receive reduced or no funding might leave the field, because private support would probably not increase enough to offset this reduction. Opponents are especially concerned that cutbacks could seriously hurt research in diseases such as Acquired Immune Deficiency Syndrome and Alzheimer's disease, depending on priorities established by the Congress and NIH.

NDD-31 ELIMINATE SUBSIDIES FOR HEALTH PROFESSIONS EDUCATION

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	220	230	240	250	260	1,210
Outlays	70	180	220	240	250	960

Congress provided funds totaling $209 million in 1988 to institutions and students to promote graduate education for physicians, nurses, and public health professionals. The three largest programs, funded by the U.S. Public Health Service, are for primary care specialists, nurse midwives and nurse practitioners, and minorities in the health professions:

- Primary care grants. These subsidies provide incentives for teaching hospitals to expand and improve graduate medical education programs in the primary care specialties. Funding for 1988 is $64.4 million.

- Nurse training. These subsidies to nursing schools are designed to increase the numbers of two specialties--nurse midwives and nurse practitioners--and to increase graduate training for nurse administrators. Funding for 1988 is $54.0 million.

- Disadvantaged student assistance. This program is the principal federal program designed to increase the numbers of minorities and disadvantaged individuals who pursue careers in the health professions. Only 20 percent of the funds go directly to disadvantaged students; the rest go to the professional schools. Funding for 1988 is $27.4 million.

- Other health professions subsidies. The remaining subsidies support a variety of educational efforts including scholarships, specialized training in geriatric care and pediatric emergency care, and on-site training in medical personnel shortage areas. Funding for all other health professions activities in 1988 is $63.0 million.

Eliminating these subsidies would save roughly $1 billion over the 1989-1993 period.

Those who oppose the subsidies cite three main reasons for eliminating them. First, market forces should provide incentives for physicians and nurses to prepare for the specialties and locate in the geographic areas of greatest need, because health care professionals are no longer in short supply. Physicians--the principal health profession targeted by the subsidies--rapidly increased in number from 142 physicians per 100,000 people in 1950 to 161 per 100,000 in 1970 and to 228 per 100,000 in 1985. The number of nurses has been stable in recent years, but the number of hospital admissions has been declining. Second, students in the well-paid health professions should be able to finance their own education by borrowing against their future income. For example, physicians--the highest-paid group--earned an average of $120,000 in 1986. Nurses, although not as highly paid as physicians, had average starting salaries of about $20,000 in 1987, comparable to those of business administration graduates in the same year. Finally, the subsidies--which go mostly to institutions--may have little or no effect on the numbers or characteristics of people studying to be health professionals.

An argument against eliminating the subsidies is that they may still have some desirable effects. The incentives supplied by market forces may not suffice in all cases because third-party reimbursement schedules do not reward primary care well enough--particularly outside major metropolitan areas--to get physicians to enter primary care or go to less-populated areas. Minority and disadvantaged groups may also benefit from having health professionals who share their backgrounds. For example, Hispanic patients may respond better to Hispanic physicians.

NDD-32 SHIFT HOUSING ASSISTANCE FROM NEW CONSTRUCTION TO VOUCHERS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	1,200	1,250	1,300	1,350	1,350	6,450
Lending Authority	380	400	420	440	450	2,100
Outlays	--	50	120	190	250	610

A number of federal programs administered by the Department of Housing and Urban Development (HUD) address the housing needs of lower-income households. Rental assistance is provided through two basic approaches: subsidies tied to projects specifically constructed for low-income households, and subsidies that enable renters to choose standard housing units in the existing stock of private housing. In recent years, the production-oriented approach has been sharply curtailed in favor of the less costly existing-housing approach. The largest new construction program that is still active is Section 202/8 for the elderly and handicapped. For 1988, less than one-fifth of additional commitments is for construction of new dwellings, while the remaining incremental aid is provided through the Section 8 existing-housing and voucher programs.

Appreciable savings could be realized by further reducing commitments for the Section 202/8 program--from 10,900 to 4,000, for example--and replacing them with vouchers. This option would slightly increase outlays in 1989 but would save $610 million over the 1989-1993 period, relative to the baseline, with additional savings continuing to accrue for more than 20 years thereafter. Short-term savings in outlays would result primarily from reductions in direct loans to developers of the projects, while long-term savings would accrue because of the lower subsidies associated with vouchers compared with Section 202/8 aid. (The reduced need for direct loans would also generate savings in lending authority. The short-term savings in budget authority resulting from the shorter contract term of vouchers--5 years versus 20 years--would be offset by higher budget authority in future years. In contrast, the savings in budget authority related to the lower subsidies associated with vouchers would not be offset.)

Support for this option comes from those who see little need for subsidizing new construction. The overwhelming housing problem today--according to this view--is the inability of poor households to afford the rents that existing units command, rather than a shortage of rental units. Furthermore, even if there are shortages, subsidizing new construction can, at best, have an impact only with a long lag because it is slow to be put in place. Moreover, subsidizing new construction may merely displace private activity rather than add to the total housing stock. Vouchers could help alleviate high housing expenditures for poor households at a faster rate and at much lower cost to the federal government than using new construction. In addition, vouchers would give households greater flexibility in choosing where they want to live.

On the other hand, national statistics on the supply of rental units may mask local shortages in units suitable for the elderly and the handicapped that rent for amounts within HUD's guidelines. Many elderly and handicapped households need housing that can provide special social and physical services not available in their current residences, but some analysts contend that the private sector does not respond adequately to these needs.

NDD-33 STOP OR SLOW DOWN THE EXPANSION OF THE POOL OF HOUSING ASSISTANCE COMMITMENTS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Stop Expansion						
Budget Authority	4,950	5,250	23,500	18,800	18,000	70,500
Outlays	10	220	680	1,200	1,700	3,800
Slow Down Expansion						
Budget Authority	1,800	1,950	20,050	15,150	14,250	53,200
Outlays	5	65	220	410	610	1,300

Every year the Department of Housing and Urban Development (HUD) makes new 5- to 40-year commitments under the Section 8 and public housing programs to provide rent subsidies for a number of low-income households in addition to those already receiving aid. The amount of additional assistance is determined by the Congress. By the end of fiscal year 1987, about 4.2 million subsidy commitments were outstanding for all rental programs combined, and about 4.0 million households actually received rental aid. Outlays for all assisted rental housing under these programs--including operating subsidies and capital costs of modernizing and developing public housing units--totaled $12.3 billion for fiscal year 1987. Even if no net additional commitments are made after fiscal year 1988, expenditures will rise to almost $17 billion by 1993. This increase will take place because some outstanding commitments have not yet resulted in households actually being assisted and because subsidies per household increase annually as a result of inflation in rents. If new commitments are funded in 1989 and thereafter at the rate assumed in CBO's baseline projection for 1988--around 90,000 net new commitments per year--the total number of assistance commitments would grow to over 4.7 million by 1993, and total outlays would increase to over $18.5 billion.

Stop Expansion. Appreciable savings could be realized if no new commitments were made for the next five years, thus freezing the number of assistance commitments at the current level. Budget authority requirements would be restricted to the cost of replacing subsidies for expiring commitments and for commitments lost because of demolitions or landlords' opting out of the programs, while keeping the level of funding for modernizing decaying public housing projects constant. Assuming that all expiring or lost commitments were replaced with five-year vouchers, this option would generate reductions in outlays of $10 million in 1989 and $3.8 billion over the 1989-1993 period, with additional savings continuing to accrue for up to 20 years more, when all contracts associated with 1989-1993 budget authority would have expired. (Because a major part of the savings in budget authority derives from replacing expiring commitments with short-term vouchers rather than with commitments of the same types and contract terms as those expiring, these savings would be largely offset by higher budget authority requirements in future years.)

A rationale for this cut is that expansion of rental assistance programs would be inappropriate at present in light of cutbacks in other areas. Furthermore, the pool of outstanding commitments would continue to aid many new income-eligible households each year because of turnover among assisted renters. Finally, the existing uneven treatment of households in similar economic circumstances--some of whom receive subsidized housing and some of whom do not--would not be exacerbated. Arguing against the cut is the fact that annual net increments in assisted housing have already been decreased sharply during this decade--from about 188,000 in 1980 to 90,000 in 1988--and fewer than 35 percent of all eligible households are served by current programs. Thus, as the number of eligible households continues to grow over time, the proportion of eligible households aided would decline further and the need to ration aid would increase.

Slow Down Expansion. Alternatively, program coverage could continue to be expanded but at a slower pace. For example, just enough additional commitments could be funded to keep the share of the eligible population served roughly at the current level. This would involve adding about 60,000 net new commitments each year. Assuming that expiring commitments would be replaced with five-year vouchers, this option would reduce outlays in 1989 by $5 million and by $1.3 billion over the 1989-1993 period and would generate savings for many years thereafter.

In contrast to the first option, this strategy would slowly increase the pool of outstanding commitments and prevent a decline in the proportion of eligible households served. Nevertheless, uneven treatment of similar households and the need to ration aid would persist.

NDD-34 REDUCE FEDERAL EXPENDITURES FOR LOW-INCOME RENTAL ASSISTANCE PROGRAMS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Section 8 Programs						
Budget Authority	95	120	190	270	230	890
Outlays	200	400	630	880	1,100	3,200
Public Housing Operating Subsidies						
Budget Authority	95	200	320	450	580	1,650
Outlays	45	140	260	380	510	1,350

In general, federal rental assistance programs--primarily the Section 8 and public housing programs--administered by the Department of Housing and Urban Development aid low-income renters by paying the difference between 30 percent of the tenants' adjusted incomes and either the actual cost of the dwelling or, under a recently enacted voucher program, a payment standard. In 1987, average federal expenditures per household for all rental housing programs combined were about $3,100--including both housing subsidies and fees paid to administering agencies.

Savings in outlays could be achieved by reducing federal payments on behalf of recipients. To diminish the impact of this change on assisted tenants, state governments--which currently contribute no funds toward federal housing assistance programs--could be required to make up some or all of the decrease in federal subsidies as a condition for receiving federal rental assistance commitments from newly appropriated funds. Increasing combined tenant and state rent contributions over a five-year period to 35 percent of adjusted income would save $200 million in federal outlays for the Section 8 programs in 1989 and a total of $3.2 billion over the 1989-1993 period. Similarly, this option would increase rental income in public housing projects. Federal outlays would fall, however, only to the extent that operating subsidies were decreased in the future. If federal appropriations were cut by the amount of increased rent collections, savings would amount to $45 million in 1989 and $1.4 billion over the five-year period.

One rationale for involving states in housing assistance is that these programs generate substantial local benefits including, for example, improved quality of the housing stock. If the states became involved and each state paid close to 5 percent of the adjusted incomes of its recipients, housing costs for assisted families would increase little. Moreover, since eligibility for housing assistance is determined by each area's median income, tying states' contributions to tenants' incomes would ensure that lower-income states would pay relatively less per assisted family than would higher-income ones. Finally, even if a state contributed little or nothing and tenants' rent payments increased to 35 percent of their adjusted incomes, these out-of-pocket costs would still be well below the close to 50 percent of income that the typical renter who is eligible for assistance now pays.

On the other hand, unless all states made up the full reduction in federal assistance, this strategy would increase housing costs for some current recipients and generate unequal treatment of assisted renters across the nation. Moreover, raising rent payments could prompt some stable, slightly higher-income tenants to leave assisted housing projects in areas of the country where unassisted housing of the same quality would now be cheaper. This outcome would change the economic mix of households in these projects, reduce their viability, and increase the average cost of subsidizing them.

NDD-35 CLOSE DOWN INEFFICIENT OR UNDERUSED UNITS IN VETERANS ADMINISTRATION HOSPITALS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	55	110	130	140	140	580
Outlays	50	110	130	140	140	570

The Veterans Administration (VA) operates a nationwide medical care system that includes 172 hospital centers, 120 nursing homes, and 229 outpatient clinics. Many of the facilities are treating increasing numbers of patients: most of these hospitals are large and have been modernized and kept well staffed, thereby maintaining access to high-quality care for eligible veterans. Other facilities have experienced a declining demand for services, such as major surgery or general acute-care procedures, as the result, for example, of declining local veteran populations. At some centers, low demand for care has made it difficult to justify maintaining a skilled medical staff. The VA has started closing three surgical units and converting two small hospitals to nursing homes or extended-care facilities in the last year.

The VA could achieve greater efficiency in its system by ceasing operation of a larger number of small hospitals or underused hospital units. If only about 2 percent of VA hospital beds were selected for closing, federal savings would total about $570 million between 1989 and 1993. The criteria for selecting units could include the existence of adequate alternative sources of care, as well as low use rates for the VA facilities. Complete conversion of facilities to nursing homes or outpatient clinics might also be appropriate in some areas.

The advantage of this strategy is that it would reduce the number of expensive surgical and other acute-care units with low average caseloads or occupancy rates. Recent VA studies indicate that at least 10 percent of VA hospitals fall into the underused category for one or more of their acute-care services. Transferring such operations to other VA hospitals or to adequate private facilities would not eliminate VA care for veterans, but it would provide needed care more economically and, in many instances, improve the quality of care whenever veterans were transferred to facilities with greater professional resources.

This option could effectively eliminate some veterans' access to services, however, particularly if they perceived that VA care was no longer available to them. Even if this did not occur, some veterans would find it more difficult to obtain care, especially in rural areas.

NDD-36 END FUNDING FOR THE LEGAL SERVICES CORPORATION

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Budget Authority	320	330	340	360	370	1,720
Outlays	280	330	340	360	370	1,680

The Legal Services Corporation (LSC)--an independent, not-for-profit organization established in 1974 legislation--supports free legal assistance to the poor in civil matters. About 300 state and local agencies receive LSC grants that are paid for by federal appropriations. The President's 1989 budget proposes an 18 percent reduction in funding for LSC; in previous years the Administration attempted to abolish the program, despite its Congressional support. The option of terminating federal appropriations to LSC would generate five-year outlay savings of about $1.7 billion through 1993.

From its inception, the LSC has been the subject of much controversy. Proponents of this option charge that the activities of legal aid lawyers too often focus on the advancement of social causes rather than on the needs of poor people with routine legal problems. LSC critics believe that the responsibility for legal assistance to the poor should rest not with the federal government but with states and localities. From this perspective, reprogrammed support from other federal grants and expanded support from private sources, including donated services, could help to meet local needs for legal aid. Federal funds for social services block grants totaled $2.7 billion in 1987, nearly 9 times the funding level for LSC. Nonfederal donations make up about 25 percent of cash resources at the field level, and in recent years services donated by private attorneys have expanded greatly. This option, critics argue, would give localities more control over legal aid programs and would thus permit services to be more responsive to local needs.

Opponents of the option argue that a specifically targeted federal assistance program is the only way to ensure that legal aid is available to people who cannot pay. They point out that the inadequacy of local and private support was one of the factors that led to direct federal financing in the first place, and they believe that a strong federal program provides essential oversight and national direction. Some even argue that federal support should be increased. Currently LSC supports only about half the number of field attorneys prescribed by its own program standards. Also, in response to the continued criticism that LSC lawyers act too often as social activists, proponents of the program point out that the Congress, through legislation, has curtailed the activities some observers find objectionable.

NDD-37 MODIFY THE DAVIS-BACON ACT BY RAISING THE CONTRACT THRESHOLD AND ALLOWING UNRESTRICTED USE OF HELPERS

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	660	670	680	670	670	3,350
Outlays	170	430	550	610	650	2,400

Since 1935, the Davis-Bacon Act has required that "prevailing wages" be paid on all federally funded or assisted construction projects of $2,000 or more. Procedures for determining prevailing wages in the area of a construction project, and the classifications of workers receiving them, in some cases favor union wage rates, although recent changes in regulations have lessened this effect. The act also restricts use of lower-wage, less-skilled workers such as helpers. Under current regulations, wages for helpers are usually not determined separately, with the result that most workers on covered projects are paid journeymen's wages.

Federal outlays for construction could be reduced by raising the threshold for determining projects to be covered by Davis-Bacon, by allowing unrestricted use of helpers, or by doing both. The specific option depicted in the table would raise the threshold from $2,000 to $250,000 and allow unrestricted use of helpers. These measures would reduce outlays by about $170 million in 1989 and about $2.4 billion over the 1989-1993 period, assuming that federal agency appropriations were reduced to reflect the anticipated cost savings. Most of the savings would result from the increased use of helpers; allowing their unrestricted use, while not changing the threshold, would reduce outlays by about $2.2 billion over this five-year period. (Allowing unrestricted use of helpers and raising the threshold to $25,000 or to $1 million would reduce outlays over this five-year period by about $1.9 billion or $2.7 billion, respectively.)

Relaxing Davis-Bacon standards would help reduce the cost of federal construction projects. In addition, unrestricted use of helpers probably would increase employment opportunities for less-skilled workers on federal projects. Raising the project threshold to $250,000 would exclude about 7 percent of the value of all contracts currently covered by the act. (Setting the threshold at $25,000 would exclude only 1 percent, and setting it at $1 million would exclude slightly less than 20 percent.)

On the other hand, such changes would lower the wages of construction workers. Moreover, opponents argue that relaxing Davis-Bacon standards could jeopardize the quality of federally funded or assisted construction projects.

NDD-38 MODIFY THE SERVICE CONTRACT ACT BY ELIMINATING THE SUCCESSORSHIP PROVISION

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	120	130	140	140	150	670
Outlays	120	130	130	140	150	670

The McNamara-O'Hara Service Contract Act of 1965 sets basic labor standards for employees working on government contracts in which the principal purpose is to furnish labor services, such as laundry, custodial, and guard services. Contractors covered by this act generally must provide their employees with wages and fringe benefits at least equal to those prevailing in their locality or those contained in a collective bargaining agreement of the previous contractor. The latter provision applies to successor contractors regardless of whether their employees are covered by a collective bargaining agreement.

One method of reducing the cost of services procured by the federal government would be to permit successful bidders to pay lower wage rates or provide less in fringe benefits than their predecessors, as long as they satisfied the rules governing prevailing wages. Doing so would reduce outlays by about $120 million in 1989 and about $670 million over the 1989-1993 period, assuming that federal agency appropriations were reduced to reflect the anticipated cost savings.

In addition to reducing federal procurement costs, this option could promote greater competition among contractors. The current rule is likely to discourage potential new contractors from bidding on contracts in which the existing provider has a collective bargaining agreement, unless they have similar agreements.

On the other hand, the successorship provision is intended to prevent bidders from undermining existing collective bargaining agreements. Eliminating this provision would probably reduce the compensation of some workers in firms that provide services to the government. Some supporters of the provision argue that a reduction in compensation would, in turn, reduce the quality of such services.

CHAPTER VII

FEDERAL WORK FORCE

In 1988, the federal government will disburse about $125 billion to meet its civilian employee payroll and to cover the costs of benefits, including those for former employees and their families. Such spending, representing about 12 percent of federal outlays, is often targeted for reduction in debates on the federal budget deficit. This section presents eight options for reducing costs associated with the government's civilian work force--five address employee pay and benefits, one addresses government travel expenses, and two address the size of the federal work force. Most of the items are variations or extensions of measures the Congress has considered or adopted in past efforts to reform government operations and control costs.

Consistent with past actions to restrain the size and timing of pay raises, the first option (FWF-01) suggests different approaches to limiting the cost of both annual and the so-called "within-grade" pay raises. Options FWF-02 and FWF-03 address the savings associated with providing less liberal retirement benefits. The restrictions on future cost-of-living adjustments described in FWF-03 build on reforms adopted in 1986 for both military and civilian retirement.

Option FWF-04 would require the U.S. Postal Service to bear the full cost of certain retirement benefits currently funded by federal taxpayers. FWF-05 would reduce costs of employee health insurance by introducing to the Federal Employees Health Benefits program a prospective payment system for hospitals similar to that adopted earlier for military health insurance.

Options FWF-06 and FWF-07 both would reduce federal civilian compensation costs--the former by cutting federal civilian employment, the latter by expanding contracting out. The last option (FWF-08) would limit funding for employee travel.

Many of the options require reductions in agency spending to realize the savings indicated. The Congress could achieve such reductions by cutting agency appropriations or by authorizing and directing the Office of Management and Budget to withhold funds from agencies. All the savings estimates set out in this section assume each reduction measure would be implemented alone. If they were carried out together, savings would be less than the sum of the amounts indicated for each item.

FWF-01 CURTAIL PAY ADJUSTMENTS FOR FEDERAL CIVILIAN EMPLOYEES

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Cap Annual Pay Adjustments at 2 Percent						
Budget Authority	1,200	2,650	4,150	5,750	7,400	21,150
Outlays	980	2,400	3,950	5,550	7,250	20,130
Delay Annual Pay Adjustments by Three Months						
Budget Authority	780	830	840	870	910	4,230
Outlays	640	830	860	890	930	4,150
Cap Within-Grade Pay Adjustments at Half						
Budget Authority	150	440	730	1,000	1,300	3,620
Outlays	120	390	690	1,000	1,300	3,500
Delay Within-Grade Pay Adjustments by One Year						
Budget Authority	310	700	950	1,200	1,350	4,510
Outlays	250	630	930	1,200	1,400	4,410

Current law provides for two types of adjustments in federal employees' salaries and wages. White- and blue-collar workers may receive annual pay adjustments under procedures that compare federal and private-sector salaries for comparable jobs. Most employees also receive periodic increases in pay based largely on length of service--the so-called "within-grade" raises. Changing the timing or the size of either type of federal pay adjustment could substantially reduce federal costs for nonpostal personnel. Any of the suggested limitations could be carried out alone or in some combination with others. To realize savings from curtailed pay raises, the Congress would need either to lower appropriations in recognition of reduced agency spending for pay, or to institute a mechanism that withholds from obligation agency funds already appropriated. (CBO estimates represent payroll savings from a baseline that anticipates annual pay adjustments averaging 4 percent through 1993 and no changes in either the timing of annual adjustments or the procedures for granting within-grade pay raises.)

Cap Annual Adjustments or Delay Them Three Months. Budget reconciliation legislation prescribes for 1988 a 2 percent government-wide pay adjustment. In addition, the adjustment will be delayed three months. (White-collar workers' pay will rise in January rather than October; blue-collar pay will continue to rise at different times throughout the year but three months later than normal.) Limiting pay raises to 2 percent over the next five years would yield savings of $20.1 billion through 1993. As an alternative, the three-month delay could be extended for the next five years. Such action would save $4.2 billion through 1993.

Advocates of pay limits argue that they are necessary in light of projected large budget deficits. Financially strapped private firms, after all, have been forced to limit, freeze, or even cut workers' pay. The limits on annual adjustments set forth here, moreover, would not differ that much from recent practice. Annual raises in federal wages and salaries over the last five years have averaged about 2.5 percent, and beginning in 1984 each year's pay adjustment has been delayed by three months.

The case against pay limits in general rests largely on concerns about employee morale and the ability of the government to recruit and retain a well-qualified work force. Concerns also arise over the alleged inequity of continued limitations. Federal employees and their representatives argue, for example, that federal workers have already sacrificed abundantly to reduce the deficit. They point out that not once since October 1977 have federal pay adjustments occurred at the levels provided for under law to make federal pay comparable with private-sector rates. As a result, salaries for most white-collar workers are estimated to lag behind comparable private-sector rates by more than 20 percent. Continued limits on federal pay would probably mean further erosion of federal rates relative to those in the private sector. The pay limits would also lead, over the next five years, to a 10 percent loss in real wages and salaries.

Cap Within-Grade Adjustments or Delay Them One Year. Within-grade pay raises currently average 3 percent for white-collar workers and 4 percent for blue-collar workers. The waiting period between raises ranges from about six months to three years depending on workers' pay schedules and time spent in a job. Capping the size of within-grade raises at half their current levels would yield savings through 1993 of $3.5 billion. (Adopting a permanent cap would necessitate adding within-grade pay steps or lowering the top rates of individual pay grades.) Instead, one year could be added to the waiting periods between raises, with savings reaching $4.4 billion over five years. In past debates on budget reduction, limits on within-grade raises have been considered but not adopted.

Limiting within-grade pay raises may be less disruptive than limiting annual adjustments, as workers would be affected only periodically--when they would otherwise have been eligible for such an increase. Furthermore, limits on within-grade adjustments might prompt workers to improve performance so as to gain through promotion or bonuses. On the other hand, any change in the rules governing within-grade adjustments would violate the terms of federal employment. These changes, moreover, could cause managers to pursue other avenues to retain and reward experienced workers. Such actions could diminish the savings available from limiting within-grade pay raises.

FWF-02 REDUCE FEDERAL EMPLOYEE RETIREMENT BENEFITS

Savings/Additions Relative to CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Totals
	1989	1990	1991	1992	1993	
Restrict Agency Match on Thrift Plan Contributions to a Uniform 50 Percent Rate						
Outlays	50	90	120	130	150	540
Base Initial Benefit on Four-Year Average Annual Salary						
Outlays	5	30	70	120	160	385
Raise Employee Pension Contributions by 0.5 Percent of Pay						
Additional Revenues	400	400	400	400	400	2,000

Federal civilian workers hired after January 1984 must participate in Social Security's retirement and disability program. To supplement this coverage, the Congress enacted the Federal Employees' Retirement System (FERS) to provide these workers with a defined-benefit pension plan and a tax-deferred Thrift Savings Plan with matching employer contributions. The number of FERS employees, currently estimated at 800,000, will grow significantly over the next decade because all new hires will be covered. The Congress also provided the 2.2 million workers hired before January 1984 with a choice of retirement plans. They could remain covered by the Civil Service Retirement System (CSRS), or they could join FERS. More than 2 million workers elected to continue their CSRS coverage, which is independent of Social Security. These workers can also participate in the Thrift Savings Plan, but without the benefit of any matching employer contributions.

The Congress could curtail retirement costs to the government, as an employer, by increasing employee contribution rates for CSRS and

FERS, by moderating initial benefit levels, or by restricting the agencies' matching rate on voluntary contributions made by FERS employees to the Thrift Savings Plan. A lower matching rate would not automatically result in budgetary savings, however, unless commensurate reductions in agency spending were achieved--either by authorizing the Office of Management and Budget to withhold funds or by appropriating lower funding levels. Limiting the postretirement indexation of federal pensions offers another approach to reducing benefit costs. (See ENT-22 and FWF-03.) The President's budget for 1989 would not change federal retirement benefits.

The strongest case against reducing these benefits is that the relative generosity of federal retirement programs has clearly been a substitute for below-market pay. Erosion of the value of the retirement package, with no change in federal pay practices, would lower total compensation and would eventually affect the quality of the federal work force.

Restrict Agency Match on Thrift Plan Contributions. On behalf of any worker covered by FERS, federal agencies automatically contribute 1 percent of individual earnings to the Thrift Savings Plan. In addition, any voluntary deposits made to the Thrift Plan by a FERS participant, up to 5 percent of earnings, are matched by the employing agency. But the marginal rate of the agency match declines with the level of voluntary savings: employee deposits up to 3 percent of earnings are matched at a 100 percent rate, and deposits between 3 percent and 5 percent are matched at 50 percent. If an employee deposits 5 percent of pay, for example, the agency match equals 4 percentage points, or an average match rate of 80 percent.

This option would continue the automatic 1 percent contribution, but would match employee deposits up to 5 percent of pay at a uniform rate of 50 percent. The total maximum agency contribution to the Thrift Savings Plan would thus decline from 5.0 percent of covered earnings to 3.5 percent. Assuming a January 1989 effective date, reducing the employer match would produce outlay savings through 1993 of $0.5 billion. (Agency contributions to the Thrift Savings Plan are treated as federal outlays, similar to disbursements for wages and salaries. This estimate excludes savings realized by the Postal Service, which would total $0.3 billion through 1993, because reductions in postal operating costs are eventually passed on to mail users.)

Alignment with practices representative of private employers is a long-standing goal for federal employees' compensation. But total federal compensation is less than what it would be if the government adopted typical private-sector pay and benefit provisions. Higher federal pay rates coupled with lower deferred compensation from the government's retirement and thrift plans would improve comparability. Private employers typically match an individual's voluntary thrift plan deposits up to 6 percent of pay at a 50 percent rate. Thus, the federal thrift plan as modified by this option would remain superior to most employer-provided matches because of the 1 percent automatic agency contribution. Reducing the government's thrift plan contributions could help justify higher federal pay--at least for those positions for which it is difficult to attract and retain highly qualified workers--though doing so would erode budgetary savings.

Because the FERS program is so new, changing a major element like the Thrift Savings Plan at this time could be perceived as unfair. It would tend to discredit new retirement system commitments--reached after more than 30 months of analysis and debate by the Administration, the Congress, and employee representatives. Especially hard hit by changes in FERS would be higher-salaried professional and administrative employees. These workers, who already face some of the widest salary disparities with the private sector, are more likely than other FERS employees to participate in the savings program. Many of them elect to make voluntary contributions at or above 3 percent of earnings, and halving the 100 percent agency match would be roughly equivalent to a 1.5 percent pay cut for this relatively small group. This option would be most unfair to the former CSRS employees (fewer than 200,000) who just elected to transfer future federal retirement coverage to the FERS program. If the government intends to renege on its commitment to the original thrift matching rates, these workers might demand the right to reconsider their decision.

Moderate Initial Benefit Levels. Both CSRS and FERS calculate initial benefits based on the employee's highest average annual salary over three years. This option would institute a four-year average; five years is generally used for defined-benefit pension plans in the private sector. Adopting the four-year average would cut new retirees' pensions by 2 percent to 3 percent. To discourage workers from accelerating their planned date of retirement in order to avoid a benefit cutback, any change in calculating benefit levels could be phased in. For estimating purposes, CBO assumed the salary base would increase from 36 months to 48 months during 1989. Through 1993, this would save about $0.4 billion. Another approach would grandfather the three-year average for employees currently eligible to retire. In either case, adopting a four-year average for calculating CSRS and FERS defined-benefit annuities would yield relatively small outlay savings initially. But as more and more employees retire, significant savings would accrue. On an actuarial or long-term accrual cost basis, the change in the salary base used for calculating retirement benefits would save the equivalent of 0.7 percent of CSRS-covered payroll and nearly 0.5 percent for FERS. (Because the pension for CSRS is larger than the defined benefit portion of the FERS annuity, the savings impact is larger.)

CSRS and FERS employees would argue that their retirement benefits have already been cut indirectly by caps on annual federal pay raises. During the 10 years ending December 31, 1987, the rise in private-sector salaries and wages as measured by the Employment Cost Index exceeded the cumulative increase in federal pay rates by about 20 percent. A federal civilian pay raise of 1 percent over a 12-month period would cost about $0.6 billion. Thus, any serious attempt to correct the existing imbalance between federal and private pay rates would cost much more than retirement savings available from the adoption of a four-year average salary base.

Raise Employee Pension Contributions. Compared with the typical cost of private employer-provided retirement benefits (pensions and capital accumulation plans coupled with the costs of Social Security), CSRS and FERS benefit costs are high. Although mandatory retirement contributions for most CSRS employees are 7 percent of pay (and FERS employees pay less than 1 percent in addition to their Social Security contributions), the cost to the employer is still higher than in private plans. Thus, increasing CSRS and FERS employee contributions by 0.5 percent of pay would improve the alignment between the federal government's cost of retirement benefits and those of private employers. It also would lower the 1989 deficit by $0.4 billion and generate cumulative savings through 1993 of $2.0 billion. (The estimated savings assume an effective date of October 1988.)

By reducing take-home pay, this option is about equal to a cut in the next general pay adjustment of 0.5 percentage points. (See FWF-

01 for options to curtail federal pay raises directly.) From the employees' perspective, a pay cut affects career and noncareer workers equally, whereas hikes in pension contributions can be recovered by noncareer workers when they leave federal service.

FWF-03 CAP COST-OF-LIVING ADJUSTMENTS FOR FEDERAL RETIREES UNDER AGE 62

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Military Retirement	80	200	350	500	670	1,800
Civilian Retirement	30	60	90	130	180	490
Total	110	260	440	630	850	2,290

NOTE: Amounts represent outlay savings.

The Civil Service Retirement System (CSRS) and the Military Retirement System (MRS) provide benefits for about 3.7 million people at an annual cost of $46 billion. About 60 percent of MRS beneficiaries and 10 percent of CSRS beneficiaries are nondisabled retirees under age 62. Benefit payments in 1988 for this relatively young group total $15 billion. Cost-of-living adjustments (COLAs) for federal retirees who begin receiving benefits before age 62 are fully paid for by the government and are expensive relative to adjustments available under the largest and most generous private pension plans.

This option, using a two-step approach, would cap the annual COLAs for nondisabled retirees under age 62 at one percentage point below the inflation rate as measured by the Consumer Price Index (CPI), and would grant a catch-up raise at age 62 to account for inflation since retirement. It would provide full COLAs after age 62. (Although the catch-up adjustment restores the monthly pension to what it otherwise would have been at age 62, the annuitant is never compensated for the smaller benefit payments received during the time COLAs were capped.) The COLA limitation would cause outlays through 1993 to fall by $2.3 billion--less than 1 percent of total outlays otherwise disbursed during the same period for the CSRS and MRS systems. About 90 percent of the losses would be taken by current retirees, and the rest by those retiring in the next five years.

Military and civilian retirement reforms enacted in 1986 reduced the future cost of federal pensions for newly hired employees. The military system reforms curtail benefits for newly hired personnel by reducing most initial annuities and by capping COLAs at the rate of inflation less one percentage point (CPI-1%). But at age 62, in a manner consistent with this option, future military retirees will receive a catch-up adjustment that restores the purchasing power lost since retirement. Nondisabled civilian retirees under the new system, on the other hand, will not receive any COLA until age 62, nor any catch-up raise for price increases since their retirement. For future civilian and military annuitants alike, COLAs awarded after age 62 are limited to CPI-1%. COLAs for individuals who remain covered by the old CSRS and MRS systems, by contrast, are unaffected and equal 100 percent of the CPI. (The budget proposed by the President for 1989 would not modify federal retirement provisions.)

This option would moderate the differences between retirement COLAs available to newly hired employees and those available to individuals covered by the CSRS and MRS systems. As such, it would reduce protection from inflation and thus real benefits for federal retirees of working age. The loss in retirement income would be especially pronounced for MRS employees, who retire at an average age of 43. But at age 62 and beyond, COLAs for federal pensions would remain more generous, with the catch-up, than would the partial inflation protection for those receiving private pensions combined with Social Security. Less than one-third of the retirees in the private sector are covered, in addition to Social Security, by employer-provided pension plans. These individuals typically receive pension COLAs that eventually recover 30 percent to 40 percent of general price increases, but neither the timing nor the size of the adjustments is guaranteed. Of course, Social Security COLAs are automatic and keep pace with inflation; but employees cannot draw Social Security retirement until age 62.

Alternative COLA provisions could also generate considerable near-term savings. One possibility would be to curtail adjustments for all nondisabled CSRS, MRS, and Social Security annuitants (see ENT-22, which would restrict federal retirement and Social Security COLAs). Other alternatives could pivot directly, or indirectly like this option, on the beneficiary's earnings capability. In general, financial hardships from smaller COLAs would be more pronounced for disabled and survivor annuitants than for the relatively young retirees targeted by this option, who should be in a better position to face a temporary loss in real benefits. Presumably, these young retirees are able to supplement their federal pensions by working--as most military retirees already do.

Because considerable planning and changes in personal affairs often precede decisions to retire, changing the rules for people after they retire could be perceived as unfair. CSRS employees who elected not to join the new retirement program mainly because of its weaker COLAs would also feel short-changed. (Another proposal, FWF-02, would reduce benefits under the new retirement system.) Many critics would contend that federal workers traditionally have accepted a compensation package that provided superior pensions at the expense of lower pay. Furthermore, future budgetary pressures may either erode the size of the proposed catch-up adjustment or delay it beyond age 62. Finally, this option's reduction in retirement benefits would diminish somewhat the financial reward for making a career of military service. The resulting rise in turnover of personnel with more than four years of service would engender a slight shift over the longer term to a less experienced and lower-skilled military force.

FWF-04 ELIMINATE INDIRECT RETIREMENT SUBSIDY TO THE U.S. POSTAL SERVICE

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Offsetting Receipts	0	0	1,650	1,700	1,900	5,250

As an employer, the U.S. Postal Service (USPS) makes two types of payments for the future cost of employee retirement benefits provided under the Civil Service Retirement System (CSRS). One, set at 7 percent of pay, matches the contribution of postal employees who participate in the CSRS program; the other, referred to as the "amortization payment," helps finance the future benefit increases that result from collectively bargained pay raises. Neither these payments, which total $3 billion for 1988, nor postal employee contributions fund any of the costs associated with indexing CSRS benefits to increases in the cost of living. Such postretirement increases are expensive and, as an indirect subsidy that is not recognized in postal service pricing, are paid for by the U.S. taxpayer rather than by postal customers. Shifting costs to postal customers would affect businesses more than households because about 80 percent of mail volume is business-related. The additional postage revenue generated by requiring the USPS to fund cost-of-living adjustments (COLAs) for its retirees could cut accumulated deficits through 1993 by $5.3 billion.

This option would require the USPS to fund the actuarial present value of future postretirement COLAs to be received by each year's group of new postal retirees beginning in 1991. The liability for the first group of annuitants affected by this proposal, assuming 22,000 new retirements each year and applying long-term inflation and interest rates consistent with the most recent assumptions used by the CSRS Board of Actuaries, totals $1.6 billion. The estimated additional liability for new retirees through 1993 would accumulate to just over $5 billion.

To meet the COLA costs for new retirees, the USPS would need to augment future postage rate increases. (The 1987 Omnibus Reconciliation Act, on the other hand, requires the USPS to reduce operating costs in 1988 and 1989 and to delay capital investments rather than fund the legislated, albeit temporary, increases in postal compensation costs through higher stamp prices.) The higher rate adjustments needed to pay for post-retirement COLAs would boost overall revenue requirements by about 4 percent in 1991. The option's effective date allows for consideration of the costs in the next general rate increase, assumed in the CBO baseline to occur in October 1990. (Option NDD-16 would also affect the USPS.)

Federal subsidies have been cited as giving the USPS an unfair market advantage over competing private-sector firms, leading to overuse of the USPS. Eliminating the indirect COLA subsidy for postal workers covered by CSRS would move the USPS closer to self-sufficiency. (Under retirement reforms enacted in 1986, the USPS already pays for COLA expenses of newly hired workers and those CSRS employees who elected to switch into the new system.) As an alternative to this option, the Postal Service could be charged for its COLAs on a pay-as-you-go, or cash, basis. The option also could be expanded to include the costs of COLAs of all postal beneficiaries, as proposed by the Administration. This option and its variations would continue a trend of declining federal support to postal operations.

But eliminating the subsidy, as proposed in this option, could result in overcharges to postal ratepayers. Differences between the actual and the assumed rates of interest and inflation could provide a windfall to the government at the expense of higher-than-necessary postage rates. Should future COLAs prove more costly than anticipated, however, past proposals to limit full indexation might be reinstituted. (The Balanced Budget Act eliminated the 3.1 percent CSRS adjustments for 1986, and future COLAs always remain a possible budget reduction target.) As a defense against such action, funds could be segregated for postal workers' participation in CSRS, which might reinforce the government's commitment to honor full indexation of CSRS benefits.

FWF-05 MODIFY THE WAY HOSPITALS ARE PAID UNDER THE FEDERAL EMPLOYEES HEALTH BENEFITS PROGRAM

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Budget Authority	0	230	360	420	500	1,510
Outlays	0	230	360	420	490	1,500

The Federal Employees Health Benefits (FEHB) program offers health insurance coverage for federal employees, retirees, and their dependents. In 1988, the program will cover about 4 million enrollees at a cost to the federal government of about $4.7 billion. About half of this amount pays hospitals for inpatient services provided to FEHB enrollees. Federal costs will continue to grow in future years because of higher health care prices, greater use of services, and greater numbers of retirees. (The estimated government cost excludes amounts paid by the U.S. Postal Service because such costs are eventually passed on to mail users.) Reforming hospital reimbursement, as described below, could reduce such costs and thus lower federal outlays through 1993 by $1.5 billion. (Savings estimates assume proposed changes would take effect for the FEHB contract year that begins January 1, 1990. To reduce budget deficits, the estimated savings would need to be realized through lower agency appropriations.)

Most FEHB insurance carriers pay hospitals in one of two ways--on the basis of actual charges, or on the basis of predetermined rates that have been negotiated with the hospitals and that reflect certain discounts. An alternative reimbursement system could require carriers to use a prospective payment system patterned after the one instituted last year by the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) for military personnel. The military program modified the diagnosis-related group (DRG) payment schedules used by Medicare to reflect the health care needs of younger patients. Under a modified DRG system, hospitals receive a fixed payment per case based on a patient's diagnosis and on characteristics of the hospitals that affect the costs of treating that diagnosis. Hospitals that accept federal reimbursement from Medicare would be required to accept the predetermined rate as payment for FEHB enrollees, just as they do for CHAMPUS. In some cases, the payment schedules might need modification to reflect a different age distribution of patients or other pertinent cost considerations. Savings realized by FEHB insurance carriers under this prospective payment system would allow for lower premium payments by both enrollees and the federal government. Savings to employees and annuitants could reach nearly $1 billion through 1993.

Some proponents believe that an expanded DRG reimbursement system would reinforce existing incentives for hospitals to contain costs. In their view, the current system drives up costs because hospitals tend to provide FEHB and other insured patients more amenities, more technology, and more staff than are necessary. A DRG system, by contrast, seeks to increase hospitals' efficiency. Moreover, establishment of a DRG system for FEHB patients could help pave the way for all insurers to switch to a prospective payment plan.

Opponents of this proposal voice some of the same concerns about jeopardizing the quality of health care that were raised during debate on adopting the DRG scheme for Medicare and again for CHAMPUS. Because the payment does not recognize the variation in costs related to treating different patients with the same diagnosis, hospitals would profit from cases where a patient was healthier than average and would suffer a financial loss when a patient was sicker than average. Under such economic incentives, critics would argue that hospitals may limit the care provided in some cases or possibly deny care in others. In other cases, hospitals might try to collect excess expenses directly from patients. Finally, federal budgetary pressures might lead to future DRG payments that were lower than the cost of providing adequate care to a typical patient, causing hospitals to accentuate the selection of patients on the basis of financial considerations.

FWF-06 TRIM THE SIZE OF THE FEDERAL CIVILIAN WORK FORCE

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Budget Authority	0	230	470	710	960	2,370
Outlays	0	220	470	720	990	2,400

Appropriation and other action to trim the size of the federal work force offers another way to reduce personnel costs. Eliminating the equivalent of 50,000 full-time federal jobs through 1993 would reduce the civilian work force in nonpostal Executive Branch agencies by about 2 percent from its current level of about 2.2 million and would generate outlay savings of $2.4 billion over five years. A temporary reduction in federal employment was discussed but not adopted during Congressional debate on budget measures for 1988 and 1989. In addition, the President's budget for next year recognizes, as one objective, restraining the size of the federal work force, especially at the Department of Defense. (CBO's savings estimates assume five-year reductions governmentwide and corresponding cuts in appropriations. Certain essential governmental functions, such as tax collection and public health and safety, could be exempted.)

Given normal employee turnover, this option could probably be achieved largely without layoffs. The modest employment reduction specified would require agencies to forgo filling the equivalent of roughly one out of twelve vacancies that normally occur as a result of quits and retirements from full-time permanent positions. A Congressional mandate to reduce employment would have to specify both the actions to be taken and the Executive Branch authority responsible for carrying it out. For example, the President could be required to develop and adopt annual hiring limits. To realize budgetary savings, moreover, the Congress would have to ensure that reduced employment was followed by lower agency spending--either through authority given to the Office of Management and Budget to withhold funds or through reduced appropriations.

Proponents argue that reductions in the work force could encourage improved operating procedures, more productive use of training programs, increased use of computers and other labor-saving equipment, and better agency management of human resources. More far-reaching and often-proposed reforms might also be adopted, including restructuring major Defense Department maintenance and supply activities, greater sharing of defense support services, and closing or consolidating some military facilities. Adoption of such measures would further the Administration's goal of improving the productivity of government operations and might mean that employment could be reduced without lowering the level and quality of services. The Administration has already launched a program to improve productivity in government. Productivity gains of only 0.5 percent a year through 1993 could permit elimination of about 50,000 jobs while maintaining existing levels of service. Most agencies should be able, with little difficulty, to realize such a rate of improvement. According to recent governmentwide data, labor productivity for sampled civilian nonpostal activities has risen at an average annual rate of 2.3 percent since 1980. At the Department of Defense (DoD), however, greater effort may be required in view of recent drops in productivity.

Opponents criticize across-the-board reductions as measures that avoid a careful weighing of priorities among the wide variety of federal programs. (Other options, by contrast, would reduce employment as a result of decisions to increase efficiency or to curtail specific programs. See, for example, FWF-07, DEF-19, AGR-06, NDD-22, NDD-24, NDD-25, and NDD-35.) Others believe across-the-board reductions can be counterproductive. Such reductions apply to efficient and effective programs in the same way they apply to programs that are less so. Moreover, the goals themselves may not be realistic in view of the unique limitations and mission requirements of many activities, especially those relating to important national priorities such as defense. Indeed, some observers believe that such goals would decrease the control and flexibility DoD managers need to maintain military readiness. Should agencies fail to find ways of improving productivity to compensate for employment cuts, the quality or level of services would decline.

Other critics express concern about the uncertain costs of obtaining new equipment and of other measures to improve productivity. In response to this concern, the estimated savings presented here represent net amounts from the CBO baseline after allowing for substitution of capital investment for labor and other associated costs. For estimating purposes, such costs correspond to a one-time charge of 12 months' compensation for each workyear eliminated. Any additional implementation costs are assumed to be covered by reallocating existing funds.

FWF-07 REDUCE AGENCY SPENDING IN ANTICIPATION OF MORE CONTRACTING OUT

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1989	1990	1991	1992	1993	
Budget Authority	70	220	370	540	730	1,930
Outlays	40	130	230	330	450	1,180

Private contractors can in many cases provide the government with supply, maintenance, and other support services at lower cost than can federal workers. Executive Branch policy, set forth in Office of Management and Budget (OMB) Circular A-76, requires agencies to streamline their operations and then to rely on the private sector if it is still more economical to do so. Critics of current efforts, however, suggest that the government could do much more contracting out. While it is difficult to predict precisely the extent to which contracting out would increase as a result of the measures described below, it is not unreasonable to assume that current efforts could double. Accordingly, an additional 10,000 jobs would be considered for contracting out each year. Over five years, savings would accumulate to $1.2 billion, and the equivalent of about 36,000 federal jobs would be eliminated--as a result of both contracting out and the streamlining of federal operations. Given normal employee turnover and the possibility of reassignment, job reductions could probably be accomplished without layoffs.

Several measures might be taken to encourage more contracting out. The Congress could eliminate legislative and administrative prohibitions that prevent agencies--primarily the Veterans Administration (VA) and the Department of Defense (DoD)--from considering large numbers of support activities for contracting out. Providing a specific Congressional mandate for the A-76 program offers another approach to expanding contracting out. Such a mandate could, for example, require agencies, at the direction of the President, to undertake a specified number of A-76 reviews each year. Periodic reporting to the Congress on implementation could also be required.

The Congress might also consider reducing employee resistance to A-76 policy--for example, by mandating job placement in the same commuting area for federal workers who lose their jobs as a result of contracting out.

To achieve deficit reductions as a result of contracting out, whatever methods are chosen to boost the program, the Congress would also have to ensure that A-76 activity resulted in reduced agency spending. Under current practice, the DoD, which accounts for about 70 percent of all jobs reviewed under A-76, is free to apply savings to meet other spending priorities. Any significant budgetary savings from expanded A-76 activity would therefore require reductions in DoD spending, which could be accomplished by reduced appropriations or by legislation requiring OMB to withhold from agencies funds saved from A-76 activity. CBO's estimates of budgetary savings from contracting out assume that one of these measures is used to reduce funding at DoD and other agencies that achieve savings from the A-76 program.

Advocates of contracting out point to it as economically prudent. At DoD, for example, data reveal that the A-76 program can reduce the cost of affected activities by about 30 percent on average. Supporters buttress their position by arguing that the federal government ought not to provide services available from the private sector. Much recent contracting out, for example, has been for facility support activities such as laundry, dry cleaning, refuse collection, and air conditioning maintenance, and for administrative support functions such as audiovisual services, data processing, and telephone service--all commercial activities generally available from private firms.

Opposing arguments focus largely on the lower quality of services that contractors sometimes deliver, and on the concerns of federal employees threatened by loss of jobs. Furthermore, restrictions on contracting out may be necessary to help the government fulfill its special obligations, including maintaining national security and caring for patients in VA hospitals. This reasoning assumes that, when work is kept in-house, managers retain more control over work and can better assure the quality of services.

FWF-08 REDUCE FEDERAL TRAVEL EXPENSES

Savings from CBO Baseline	Annual Savings (In millions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Savings
Budget Authority	280	300	310	320	330	1,540
Outlays	260	290	310	320	330	1,510

The Executive Branch currently spends, for nondefense agencies excluding the Postal Service, about $1.8 billion a year on employee travel. This total anticipates implementation of recent Congressional action in the continuing resolution for 1988 (Public Law 100-202) that requires the President to reduce certain agencies' expenses for employee travel, transportation, and subsistence. The $24 million reduction, representing a cut of about 15 percent from funds requested for 1988, applies to the Departments of Education, Health and Human Services (including the Social Security Administration), Labor, and to more than a dozen small, independent agencies. If, in 1989, travel spending for these agencies increased only for inflation, and appropriation action required a 15 percent cut in travel expenses for other nondefense, nonpostal agencies, savings of $1.5 billion would accumulate over five years. (If these savings are not used to increase future spending in other areas, federal budget deficits would decline accordingly.) This option is similar to a travel reduction item that was included in the Concurrent Resolution on the Budget for 1988, as passed by the Senate, but was omitted from final appropriation and budget reconciliation acts.

The General Services Administration, which manages travel arrangements for civilian personnel, reports that continued improvements in procurement methods have reduced government travel expenses. In addition, the Omnibus Reconciliation Act of 1981 imposed across-the-board limits on agencies' 1982 travel budgets. Recent budget reduction efforts, moreover, have reduced either the travel funds specifically or the general operating funds from which travel expenses are paid. Nevertheless, travel expenses for agencies, which last year averaged $1,475 per civilian employee (except postal workers), have increased faster than inflation. By the end of 1988, average annual costs per employee will have increased an estimated 62 percent over the 1982 level, while prices during the same period will have increased about 27 percent. (The increase in real travel expenses per capita during this period reflects yearly declines in 1985 and 1986 but a two-year increase since then of about 20 percent.) Although improvements effected by agencies have prevented some unnecessary travel expenses, further changes in travel management or outright reductions in the amount of travel could produce additional savings.

Carrying out this option would probably require limitations in successive annual appropriation measures, patterned after the selective one enacted last year, that would direct the President to make determinations for specific agency accounts on the amount of funds to be withheld from obligation. The President could be required either to apply a uniform percentage reduction necessary to achieve a specified total outlay savings, or to allocate the reduction among agencies based on consideration of their particular mission requirements. The mandate could again require the President, in making his determinations, to obtain advice from the Director of the Office of Management and Budget and the Comptroller General of the United States, to report his actions to the Congress, and to provide for use of apportionment and other mechanisms to assure financial accountability.

Proponents argue that an across-the-board reduction in 1989 would prompt agencies to pursue cost-saving practices more aggressively. Such practices include better monitoring of costs, eliminating low-priority travel, and making greater use of innovative procurement methods like negotiated discounts for high-volume travel.

On the other hand, enactment of a 15 percent reduction in travel expenses could create difficulties for agencies that rely heavily on travel for effective management and for carrying out mandated programs. Agencies with many field offices or contractors, for example, may face inefficiencies or added costs in other areas if required to cut travel. Moreover, the risk of inefficiencies increases as possible management improvements and cuts in low-priority travel are exhausted. Instead of cutting travel, the government might be better served by encouraging more employee review of field operations. Finally, some substitutes for travel, such as purchasing telecommunications equipment, could result in higher near-term outlays. Reducing funds for particular types of expenditures--such as travel, energy consumption, purchase of supplies, and so on--is a rigid approach that prohibits the most efficient and effective use of available resources. From this perspective, focusing reductions on travel is less preferable and more difficult to carry out than a general reduction in agency operating expenses.

CHAPTER VIII

REVENUES

Federal revenues could be raised by changing existing taxes or by introducing new taxes such as a value-added or energy tax. This section presents 25 options for raising revenues from these sources.

The first three options would raise revenues by increasing tax rates. Option REV-01 presents alternatives for raising tax rates for individuals and corporations, while REV-02 describes the effects of repealing or postponing indexing of individual income-tax rate brackets, standard deductions, and personal exemptions. REV-03 concerns increasing the rates of the alternative minimum tax for individuals and corporations.

The next 15 options are alternatives for broadening the base of the income tax. REV-04 through REV-09 would reduce or eliminate tax preferences aimed at particular activities or industries. REV-10 and REV-11 describe methods of reducing preferential treatment of capital gains. REV-12 would lessen tax preferences for pension and profit-sharing plans. REV-13 would reduce the child- and dependent-care credit for middle- and upper-income taxpayers. REV-14 and REV-15 would restrict two widely used itemized deductions, those for home mortgage interest and state and local taxes. REV-16 through REV-18 would increase the taxation of three forms of income that are nontaxable or only partially taxable under current law. These are Social Security benefits (now only partially taxable for some taxpayers), Workers' Compensation and Black Lung benefits, and nonretirement fringe benefits.

The next three options would raise payroll tax revenues. REV-19 describes alternatives for extending the Old-Age, Survivors, and Disability Insurance (OASDI) and Hospital Insurance (HI) taxes to groups of workers who do not now pay these taxes even though they may be eligible for benefits in the future. REV-20 addresses ways of increasing the HI payroll taxes of workers who are already paying HI taxes. REV-21 would raise Unemployment Insurance taxes.

Three options address taxes on consumption. REV-22 describes a value-added or national sales tax. REV-23 describes alternative excise taxes that could be imposed on energy products. REV-24 addresses ways of increasing existing federal excise taxes on telephone and telecommunications products, alcoholic beverages, and tobacco products. The final option, REV-25, gives examples of charges that could be imposed on pollution emitted during production and utility generation processes.

The estimates of revenue gains from all of the options were made relative to the CBO baseline budget forecast. The baseline is developed under the assumption that most provisions of the tax code that are currently scheduled to expire will not be extended. Most of the provisions have an effective date of January 1, 1989, because changes in income tax law are usually effective at the beginning of a new calendar year. For the excise tax options, an earlier date of October 1, 1988, is assumed. A January 1, 1990, effective date is assumed for REV-22 (the value-added tax) because it seems unlikely that this option could be implemented before then if it is enacted in mid-1988.

REV-01 RAISE MARGINAL TAX RATES FOR INDIVIDUALS AND CORPORATIONS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Individuals						
Raise Marginal Tax Rates to 16 Percent and 30 Percent	18.7	28.4	30.9	33.4	35.9	147.4
Add a 5 Percent Surtax	13.9	21.1	22.9	24.7	26.6	109.1
Raise the Top Marginal Tax Rate to 30 Percent	9.4	14.5	16.0	17.5	18.9	76.2
Add a 33 Percent Bracket	2.9	5.5	6.4	7.1	7.7	29.6
Corporations						
Increase Top Marginal Rate to 35 Percent	1.6	2.8	2.9	3.0	3.0	13.3
Add a 5 Percent Surtax	3.0	5.9	6.3	6.5	6.7	28.4

A simple way to raise revenues through the income tax is to raise tax rates. Because the base of the tax is so broad, even a small increase in rates will yield substantial revenues. Rate increases have some advantages over other tax changes: they do not add to costs of enforcement or compliance, since they do not increase the complexity of the tax code or taxpayers' record-keeping requirements; and they are reflected in withholding or estimated tax schedules, so that the Treasury begins to receive the additional revenues relatively quickly. Rate increases, however, reduce incentives to work and save, and worsen any inefficiencies associated with remaining preferences in the income tax code. They would also run counter to the changes in the Tax Reform Act of 1986 (TRA), which reduced statutory marginal tax rates significantly for both individuals and corporations in exchange for broadening the tax base.

Individuals. Under current law, the income tax structure has two explicit marginal tax rates--15 percent and 28 percent. (The marginal tax rate is the percentage of an extra dollar of income that a person must pay in taxes.) Some taxpayers face a marginal tax rate of 33 percent--a result of the top statutory rate plus a 5 percent surcharge associated with the phaseout of the 15 percent bracket and personal exemptions over a range of taxable income. In 1989, the projected phaseout range of taxable income is $44,950 to $104,510 for single taxpayers, and $74,950 to $200,350 for a couple with two children. Taxpayers with incomes above the phaseout range face a 28 percent marginal rate.

Increasing all marginal tax rates for individuals by approximately the same percentage--to 16 percent and 30 percent (with a 35 percent rate for income in the phaseout range)--would increase revenues by a large amount: about $147 billion in 1989 through 1993. An equal percentage increase in all rates would be roughly equivalent to imposing a surtax on regular tax before credits. This option would not increase taxes for those whose taxes are computed according to the alternative minimum tax, unless that tax rate were also increased (see REV-03). It would also cause families with tax credits to face a larger percentage increase in their tax liabilities than other taxpayers. Families whose Earned Income Credit (EIC) gives them a zero tax liability or an EIC refund might incur a positive tax liability as the result of this option.

An alternative to a rate increase would be to impose a surtax applied to tax liability after credits. A surtax of 7 percent would raise about the same revenues, and result in roughly the same marginal tax rates, as raising marginal tax rates to 16 percent and 30 percent, but the tax increase would be distributed differently among taxpayers. Higher taxes would be paid by all taxpayers who now face a positive tax liability, even those who pay the alternative minimum tax, but not by families who have no tax liability under current law. This form of a surtax would not affect recipients of EIC refunds. A 5 percent surtax applied to tax liability after credits would increase revenues by about $109 billion in 1989 through 1993.

Another option for raising revenues is to increase only the top marginal tax rate. Increasing only the current 28 percent rate to 30 percent (resulting in a 35 percent marginal rate for income in the phaseout range) would raise revenues by about $76 billion in 1989 through 1993. For 1989, this option would increase taxes for married couples with taxable incomes over $31,000.

Another alternative would be to drop the phaseout of the 15 percent bracket and personal exemptions and create an explicit 33 percent bracket that would apply to all income above the start of the current phaseout. Taxes would be raised only for the small number of high-income families for whom the 15 percent bracket and personal exemptions would be completely phased out under current law. This option would raise about $30 billion in 1989 through 1993, increasing taxes for about 600,000 taxpayers. For example, a married couple with two children would pay higher taxes if their taxable income for 1989 was $200,350 or higher.

All of these options would either increase the maximum marginal tax rate on capital gains or increase the number of taxpayers who would pay at the current maximum. (Under current law capital gains are treated as ordinary income and thus the maximum rate can be as high as 33 percent.) Higher marginal tax rates on capital gains can discourage investors selling assets that have appreciated.

Corporations. The top statutory tax rate on corporate income is 34 percent. Lower marginal rates apply to the first $75,000 of taxable income, but corporations with taxable income above $100,000 pay an additional 5 percent tax until the benefits of the lower marginal rates are phased out.

About $13 billion would be raised in 1989 through 1993 by increasing the top marginal rate to 35 percent. While only 10 percent of corporate taxpayers pay the top rate and would be affected by this rate change, these firms earn approximately 90 percent of all corporate taxable income. All corporations that continue to pay the alternative minimum tax would be unaffected by the change, and those with unused credits would be able to offset some of the increased tax liability.

An alternative to raising the top corporate rate would be to impose a surtax on tax liabilities. A 2.3 percent surtax would raise about the same revenues as an increase in the top rate to 35 percent; under this surtax, the top rate would be 34.8 percent. In contrast to a rate increase, a surtax would apply to corporate liabilities from the alternative minimum tax, and it also would not expand the amount of credits that corporations can claim.

An increase in the corporate rate, either directly or through a surtax, could affect the decision a business makes about its form of organization. Businesses may be organized and taxed as corporations, in which case their income is taxed at both the corporate and individual levels; if they choose a noncorporate form, their income is taxed only at the individual level. TRA lowered the maximum individual income tax rate by more than the corporate rate, increasing the incentive for corporations to reorganize into noncorporate forms. Any rate change that widens the distance between the corporate and individual rates would further increase this incentive.

REV-02 AMEND OR REPEAL INDEXING OF INCOME TAX SCHEDULES

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Delay Indexing Until 1990	3.7	6.1	6.6	7.1	7.6	31.0
Repeal Indexing	3.7	12.0	23.6	36.9	51.6	127.8

Under current law, the personal exemption amount (for years after 1989), and the standard deduction and tax bracket widths are adjusted annually to offset the effects of inflation (indexed). The Tax Reform Act of 1986 set the dollar amounts of the standard deduction (which replaces the zero bracket amount) and the tax brackets for 1988, and the dollar amount of the personal exemption for 1988 and 1989. The act also indexed the amount and phaseout level of income for the Earned Income Credit (EIC) for the first time.

Repealing indexing except for the EIC would raise revenues by about $128 billion in 1989 through 1993, assuming that inflation will average 4.6 percent over the period. Revenues from repealing indexing would grow rapidly because of the cumulative effects of inflation. Delaying indexing by eliminating only the indexing adjustment scheduled for 1989 would raise revenues by about $31 billion in the same period.

Repealing or delaying indexing would raise the taxes of most taxpayers but would not increase taxes for families that have very high incomes and itemize their deductions, because the tax liabilities of these families do not depend on the personal exemption or the 15 percent bracket. (The benefits of both personal exemptions and the 15 percent bracket are phased out for high-income taxpayers.) For taxpayers with incomes below the top tax bracket, eliminating indexing would raise tax liabilities by a greater percentage for families that use the standard deduction (generally low- and middle-income families) than for families that itemize deductions.

One argument for retaining indexing is that it requires the Congress to decide explicitly on tax increases. Without indexing, inflation causes many taxpayers to move into higher tax brackets, so that tax liabilities increase at a faster pace than income. This results in an increase in real tax liabilities without legislative action even for taxpayers with no increase in real income. Some people argue that these automatic tax increases give legislators an incentive to pursue inflationary policies and that indexing protects against this bias.

REV-03 INCREASE THE ALTERNATIVE MINIMUM TAX

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Individuals						
Raise AMT Rate to 25 Percent	1.1	3.7	3.2	3.3	3.8	15.0
Corporations						
Raise AMT Rate to 25 Percent	3.2	5.5	5.5	5.0	4.5	23.7

The alternative minimum tax (AMT) limits taxpayers' use of tax preferences to reduce their tax liability. Increasing the AMT rate would raise revenues from the individuals and corporations that benefit the most from tax preferences. However, revenue gains from these rate increases are somewhat uncertain because some taxpayers could avoid the AMT through careful tax planning. The extent to which this has occurred under the current AMT will not be known until information from tax returns filed under the tax law enacted in the Tax Reform Act of 1986 becomes available.

Raise the Individual AMT Rate to 25 Percent. The AMT for individuals is 21 percent of alternative taxable income in excess of the exemption amount--$40,000 for a joint return or $30,000 for a single return. The exemption is phased out for high-income taxpayers. Some adjustments and deductions that are allowed in computing regular taxable income are disallowed when computing taxable income for the alternative tax. These adjustments are of two types: deferral preferences, such as accelerated depreciation, excess intangible drilling costs, and profit or loss from long-term contracts; and exclusion preferences, such as the charitable deduction for appreciated property, itemized deductions of state and local taxes, some tax-exempt interest, percentage depletion, and miscellaneous itemized deductions. Two other preferences that are disallowed under the AMT will also be disallowed under the regular tax after a phase-in period; these preferences are losses from "passive" business activities and personal interest deductions other than for home mortgages. Taxpayers must pay the larger of the regular tax or the AMT. To the extent that the AMT results from deferral preferences, one year's AMT can be credited against future years' regular tax liability. Thus, a higher AMT rate shifts some future tax liabilities to earlier years.

Raising the AMT rate to 25 percent would raise about $15 billion in 1989 through 1993 and would increase progressivity by further limiting the use of tax preferences by middle- and upper-income taxpayers. This rate increase would preserve the preferences in current law, but would reduce the maximum combined tax benefit from preferences for individuals.

This option would complicate the tax system by more than doubling the number of filers who would owe an alternative tax. In addition, some preferences in the tax code are designed to encourage certain kinds of behavior; taxpayers who pay the AMT are not given these incentives.

Raising the Corporate AMT to 25 Percent. The tax base for the corporate AMT includes many of the same preferences as the individual AMT. In addition, in 1987, 1988, and 1989, the AMT base includes half of the excess of pretax book income reported to shareholders over other alternative taxable income. In 1990, this book income preference is replaced by a provision that adds 75 percent of the excess of adjusted current earnings (ACE) over other alternative taxable income. (ACE is a measure derived from earnings and profits as computed for purposes of Subchapter C of the tax code, with certain specified adjustments for depreciation and other deductions.) The current AMT rate is 20 percent for corporations. Raising the rate to 25 percent would increase revenues by about $24 billion through 1993.

The corporate AMT, with its book income preference, is intended to ensure that corporations that report profits to shareholders cannot avoid paying corporate tax. Proponents of the minimum tax argue that it improves the perceived fairness of the tax system and spreads the tax burden more evenly. Critics argue the opposite--that it places a greater tax burden on rapidly growing and heavily leveraged corporations and provides corporations with an incentive to engage in tax-motivated transactions, such as equipment leasing.

To the extent that leasing and other tax-motivated transactions are used to offset the minimum tax, the effect of the AMT would be largely cosmetic: the AMT would simply reallocate the regular corporate tax burden among corporations without raising additional revenues. In effect, a corporation would escape the minimum tax by assuming part of the regular tax liability of another corporation in exchange for cash payments. The AMT raises revenues by curtailing investment incentives and raising the cost of capital only for those firms that are hit by the minimum tax. As a result, capital is misallocated among firms.

REV-04 REDUCE TAX CREDITS FOR REHABILITATION OF OLDER BUILDINGS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Repeal Credit for Nonhistoric Structures and Reduce Credit for Historic Structures to 15 Percent	0.1	0.2	0.2	0.2	0.3	1.0
Repeal the Credits	0.2	0.3	0.4	0.4	0.4	1.7

Tax credits for rehabilitation are intended to promote the preservation of historic buildings; encourage businesses to renovate their existing premises rather than relocate; and encourage investors to refurbish older buildings. The credit rate is 10 percent for expenditures on structures built before 1936, and 20 percent for buildings certified as historic structures by the Department of the Interior because of their architectural significance.

The credits favor commercial use over most rental housing and may, therefore, divert capital from more productive uses. Commercial buildings can qualify for the 10 percent or 20 percent credit, whereas rental housing can qualify only in certified historic structures. Moreover, in favoring renovation over new construction, the credits may encourage more costly ways of obtaining more housing and commercial buildings.

Rehabilitation may, however, have social benefits: it may discourage destruction of historically noteworthy buildings. This latter objective may be accomplished at a lower cost by retaining a credit only for the renovation of certified historic buildings. Some surveys have indicated that a 15 percent credit would be sufficient to cover both the extra costs of obtaining certification and of historic-quality rehabilitation. If the credit for historic structures were reduced to 15 percent and the credit for nonhistoric structures were repealed, revenue gains over the 1989-1993 period would be about $1 billion. Repeal of the credit would raise nearly $2 billion over the same period.

REV-05 TAX INVESTMENT INCOME FROM LIFE INSURANCE PRODUCTS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Tax Inside Build-up on New Policies	a/	0.1	0.4	0.6	0.9	2.0
Treat New Policy Loans as Taxable Distributions	a/	0.1	0.2	0.3	0.5	1.0

a. Less than $50 million.

Whole-life insurance is both an insurance policy and a tax-preferred savings plan. In the early years of a policy, a policyholder pays a premium greater than needed to fund the death benefit, and the excess payment earns interest that averts the need for larger premiums as the insured person ages. The investment income, called the "inside buildup," is either tax-free or tax-deferred, depending on the circumstances under which it is paid.

If a death benefit is paid, it is not taxable to the beneficiary or, with some tax planning, to the estate of the insured person; the inside buildup is tax-free. When a policy is voluntarily canceled, the policyholder receives the cash surrender value, including the accrued interest. This amount is taxable to the extent it exceeds the policy-holder's "basis" in the policy--that is, the cumulative premiums net of dividend and loan distributions. Even though the inside buildup is taxed in this case, the policyholder has benefited from tax deferral. Finally, if the policyholder takes out a loan from the insurance company with the policy as collateral, the amount borrowed is not taxable as long as the policy remains in effect. Thus, as long as the policy is never voluntarily canceled, the policyholder can borrow and spend all of the inside buildup tax-free. Revenues could be raised by taxing the inside buildup directly, or by taxing the inside buildup when it is distributed to the policyholder in the form of a loan.

Tax Inside Buildup on New Life Insurance Policies. The interest on the savings components of whole-life insurance can be taxed just like the interest from any other savings. The savings element can be defined as the excess of the cash surrender value (the amount the policyholder would be refunded by canceling or outliving the policy) over the policyholder's investment in the contract. This investment equals premiums paid in excess of the true cost of the insurance provided (determined from mortality tables), net of any policy dividends and other distributions received by the policyholder. If the annual changes in this savings component of new policies were made taxable, about $2 billion would be raised in 1989 through 1993.

Over the five-year projection period, all of the additional tax revenue would originate from the inside buildup on new single-premium policies. These policies consist of one premium (generally a minimum of $5,000 but an average of about $30,000) that generates investment income very rapidly. In contrast, it typically takes more than five years for an ordinary level-premium policy to generate inside buildup (under current interest rate assumptions).

Proponents of this option argue that the inside buildup in whole-life insurance policies is just like any other investment income and should be taxed. This treatment would place whole-life insurance on an equal footing with other investments, such as mutual funds and bank deposits. The revenue loss from the tax preference for inside buildup is growing rapidly because life insurance contracts are increasingly being written with investment income as the primary goal. These policies, such as the single-premium life insurance policies, contain just enough death benefit to qualify for the tax preference for life insurance. They often guarantee a specified rate of return, also making them like savings accounts. These single-premium policies are very popular with high-income taxpayers, who shelter income through these instruments and accrue tax-free returns.

Opponents of this alternative argue that accrued interest from life insurance policies is more like the unrealized appreciation from a house or stock than the interest from a savings account. Viewed in this way, the income should not be taxed until the return is realized, as with equities and houses. Since the inside buildup is not distributed to the policyholder, current tax would have to be paid out of other cash saving or with a loan.

Treat Loans From New Life Insurance Policies as Taxable Distributions. For tax purposes, new policy loans could be treated first as a taxable recovery of interest income and then as a recovery of investment in the policy, which would not be taxable. All loans against new policies, therefore, would be taxable as ordinary income up to the amount of inside buildup. This option would raise about $1 billion in 1989 through 1993.

Proponents of this option argue that policy loans make the tax-free inside buildup of life insurance policies available to policyholders for their use. The borrower receives the loan proceeds tax-free, and in many cases does not have to repay the life insurance company with current funds: the loan and interest can be subtracted from the death benefit. This treatment is much more favorable than that for other tax-preferred savings plans that accrue interest, such as Individual Retirement Accounts (IRAs).

The argument against taxing the policy loan distributions resembles the argument against taxing the inside buildup directly: life insurance is an asset like a house or share of stock, which can appreciate in value. Home equity loans or loans with stock as collateral are not taxable, and yet these transactions are essentially the same as borrowing against a life insurance policy.

REV-06 TAX CREDIT UNIONS LIKE OTHER THRIFT INSTITUTIONS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Tax All Credit Unions	0.2	0.4	0.5	0.5	0.5	2.2
Tax Credit Unions with More than $10 Million in Assets	0.2	0.4	0.4	0.4	0.4	1.8

Credit unions, organized for the benefit of members and operated without profit, are not subject to federal income taxes and hence are treated more favorably than competing thrift institutions, such as savings and loan institutions and mutual savings banks. Taxing all credit unions like other thrift institutions would raise slightly more than $2 billion from 1989 through 1993. If just credit unions with assets above $10 million were taxed, slightly under $2 billion would be raised over the five-year period.

Historically, savings and loan institutions, mutual savings banks, and credit unions were tax-exempt because they were regarded as operating for the sole benefit of their members. For credit unions, membership was limited to groups sharing a "common bond," such as place of employment, membership in a church or private club, or neighborhood affiliation. In 1951, the tax exemptions for savings and loans and for mutual savings banks were removed because they were considered to be more like corporations than like mutual organizations. Since 1951, credit unions have come to resemble other thrift institutions very closely. For example, many large credit unions now offer services comparable to other thrifts, such as first and second mortgages, direct deposit, automatic teller access, preauthorized payments, credit cards, safe deposit boxes, and discount brokerage services. Since 1982, credit unions have also been allowed to extend their services to unrelated groups, prompting some credit unions to recruit members from other organizations. In fact, most credit unions have relaxed their traditional membership limits by allowing all members and their families to participate even if the member leaves the sponsoring organization. Credit union membership has grown from about 5 million in 1950 to about 55 million today. Taxable thrift institutions argue that credit unions' tax-exempt status gives them an unfair competitive advantage that is no longer justified by differences in services provided or in potential membership.

The tax acts of 1982, 1984, and 1986 greatly limited the tax preferences of taxable thrift institutions. The resulting increase in the tax burden of those institutions increases the competitive advantage that credit unions derive from escaping taxation. Credit unions contend, however, that the original reason for their special tax treatment--that they operate without profit and solely for the benefit of their members--justifies their current status.

REV-07 REPEAL TAX PREFERENCES FOR EXTRACTIVE INDUSTRIES

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Repeal Percentage Depletion	0.4	0.9	0.9	1.0	1.1	4.3
Repeal Expensing of Intangible Drilling, Exploration, and Development Costs	0.6	1.2	1.3	1.4	1.4	5.9
Bring Oil and Gas Losses Within the Passive Loss Limitation	0.1	0.3	0.3	0.3	0.3	1.3

Businesses engaged in extracting hard minerals or energy enjoy tax preferences available only to them in the form of special cost recovery rules. In addition, certain oil and gas investors are exempted from the passive loss limitation enacted in the Tax Reform Act of 1986 (TRA).

Repeal Special Cost Recovery Rules. Mineral properties, such as oil and gas wells, coal mines, or gravel quarries, are similar to depreciable assets in that they require large "up front" expenditures to produce assets that generate future income. These capital costs for mineral properties are of three types: costs associated with acquiring mineral rights and exploring for possible mineral deposits; development costs, including expenses such as those related to drilling oil wells or excavating mines; and costs for capital equipment, such as pumps or construction machinery. Under general income tax accounting principles, such capital costs may not be deducted immediately (that is, may not be expensed) but must be "capitalized" and recovered in future years through depreciation or depletion deductions. Extractive industries, however, can expense certain capital costs that normally would have to be recovered over the life of the asset, and can take depletion deductions that exceed the actual amount of other capital spending.

The items that may be expensed are certain exploration and development costs for hard mineral industries (such as coal or iron ore) and much of the cost necessary to prepare and drill wells for oil and gas (called intangible drilling costs). In the case of corporations engaged in hard mineral extraction and integrated producers of oil and gas, expensing is limited to 70 percent of these costs, with the remaining 30 percent deducted over a 60-month period.

Under cost depletion, firms are allowed to deduct costs according to the percentage of estimated reserves produced each year. For example, if 5 percent of a well's remaining reserves is produced in a given year, 5 percent of the well's unrecovered depletable costs is written off in that year. The total amount of cost depletion deductions allowed over time equals the total amount of capitalized costs. Many taxpayers, however, are allowed the alternative of percentage depletion to compute their annual depletion deduction. Percentage depletion allows firms to deduct a certain percentage of the gross income from a property as depletion, regardless of the firm's actual capitalized costs. For example, nonintegrated oil and gas companies are allowed to deduct 15 percent of the gross revenue from their first 1,000 barrels per day of oil and gas production each year. (Integrated oil and gas producers are required to use cost depletion for recovering capitalized costs.) Hard mineral producers are also allowed to use percentage depletion at varying statutory rates. Minerals eligible for percentage depletion include sand (5 percent), coal (10 percent), iron ore (14 percent), dimension stone and mollusk shells (14 percent), oil shale (15 percent), gold (15 percent), and uranium (22 percent). Percentage depletion may not exceed 50 percent of the net income from the mineral property. Thus, percentage depletion provides little or no incentive to develop or expand production from marginal properties because as production costs increase, the amount of allowed percentage depletion decreases.

The current tax treatment of mineral and energy properties has been criticized because many of the preproduction expenses of mineral properties can be deducted faster than the value of the assets they "produce" declines, providing the taxpayer with an interest-free loan of deferred taxes for a portion of the cost. For example, drilling expenditures by oil companies produce assets (that is, producing wells) that gradually decline in value as oil reserves are depleted. The tax code, however, allows taxpayers to reduce their taxes immediately by deducting most of these drilling costs in the year incurred. Moreover, percentage depletion over the life of the well often allows firms deductions that exceed their original investment. In some cases, percentage depletion (in present-value terms) is even more generous than expensing of all depletable costs. Because percentage depletion depends on the value of sales rather than the cost of the asset, it is more akin to a production subsidy than a method of cost recovery.

Because of these provisions, mineral and energy producers face effective tax rates that are lower than statutory tax rates and, for many producers, lower than effective tax rates on other industries. TRA increased the effective rates on most industries by, among other things, replacing the Accelerated Cost Recovery System (ACRS) of depreciation with one that is less generous for many assets and eliminating the investment tax credit. Tax preferences for extractive industries were not directly curtailed by TRA, although they were subjected to a more stringent minimum tax. Taxpayers hit by the minimum tax derive little or no tax benefit from percentage depletion for production during the year. They also have to defer deductions for current exploration and development costs into later tax years. Thus, as a result of the minimum tax, the tax advantages of extractive industry preferences are curtailed for certain taxpayers, but not for others. The remaining tax advantages could be eliminated by requiring all expenditures on mineral and energy rights, and on exploration, development, and drilling of productive mines and wells, to be capitalized and recovered by cost depletion. Repeal of percentage depletion would raise about $4 billion in 1989 through 1993. Repeal of the expensing provisions would raise about $6 billion over the five-year period. (This revenue estimate assumes that expenditures on dry holes, unproductive mines, or worthless mineral rights would still be expensed.)

Opponents of expensing and percentage depletion argue that these provisions are unnecessary subsidies, and cause too much capital to be allocated to extractive industries as opposed to other, more productive uses. Further, the subsidies may cause greater consumption of domestic resources (especially oil and gas) and less of imported resources. Providing the subsidies has been called a policy of "draining America first," which may result in greater reliance on foreign energy producers in the future. Finally, it is argued that the differential taxation of integrated and independent oil companies is an inefficient way of promoting oil production.

The major argument for retaining the expensing and percentage depletion provisions is that they provide necessary incentives for increasing domestic production of oil, other fuels, and hard minerals. However, given the net income limitation mentioned above, percentage depletion provides little incentive for the development of marginal properties. Proponents also argue that because the oil and gas industry is highly risky, especially for small firms, favorable tax treatment is required so that firms can raise sufficient capital. Moreover, extractive industries are facing particularly hard times, and some people argue that now is a bad time to increase their tax burden.

Exception to Passive Loss Limitation. As a result of TRA, losses from "passive" business activities (those in which the taxpayer is not involved on a regular, continuous, and substantial basis) may not be used to offset the taxpayer's other income, such as salary, interest, dividends, and active business income. This limitation was imposed to reduce the use of tax shelters. An exception was made for working interests in oil and gas properties where the taxpayer's liability is not limited by the form of ownership. Repealing this exception for the oil and gas industries would raise about $1 billion in 1989 through 1993.

This option would retain expensing and percentage depletion for taxpayers who are actively involved in oil and gas interests, but would effectively deny much of the benefit of these incentives to tax-shelter participants. Because the oil and gas exception to the passive loss limitation applies only to investors who are willing to put themselves at substantial financial risk, some argue that it does not seriously undermine the intent of the general prohibition on passive losses. This argument, however, could apply equally to other industries that are risky and that are facing adverse market conditions, such as farming.

REV-08 ELIMINATE PRIVATE-PURPOSE TAX-EXEMPT BONDS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Eliminate All Private-Purpose Tax-Exempt Bonds	0.1	0.3	0.6	1.0	1.4	3.3
Raise Cap and Extend Volume Limits to New Issues of All Private-Purpose Bonds	a/	0.1	0.2	0.4	0.6	1.4

a. Less than $50 million.

State and local governments have for many years issued bonds exempt from federal taxation to finance public investments such as schools, highways, and water and sewer systems. In the past 20 years, these governments also have issued a large and rapidly growing volume of such tax-exempt bonds to finance both quasi-public facilities, such as ports and airports, and private-sector projects, such as housing and shopping centers. Because interest on most of these "private-purpose" bonds is exempt from federal taxation, rates on them are lower than rates on other debt instruments of comparable risk and maturity. The interest rate differential between tax-exempt and taxable bonds is a measure of the federal subsidy of borrowing costs for private entities.

"Private-purpose" tax-exempt bonds include mortgage revenue bonds for rental housing and single-family homes for low- and middle-income households; industrial development bonds (IDBs) used by private firms for a wide variety of purposes; student loan bonds issued by state authorities to increase funds available for guaranteed student loans; and bonds for nonprofit institutions, such as hospitals and universities. Tax-exempt financing often merely lowers private investors' borrowing costs for investments that would be undertaken anyway. Although some bonds provide subsidies for arguably worthwhile activities, such as the development of low-income housing, tax-exempt financing is an inefficient way to provide assistance. With a direct subsidy, the benefits go entirely to the borrower, and the assistance is a line item in the federal budget rather than a less visible off-budget expenditure. With tax-exempt financing, the benefits are shared between the borrower of funds and the investor in tax-exempt bonds, and the subsidy is seldom reviewed in the budget process.

The Congress has placed restrictions on the use of tax-exempt financing several times, beginning in 1968. During the 1980s, these restrictions have included limiting the volume of new issues of tax-exempt bonds for some activities and setting expiration dates on the use of tax-exempt financing for other activities.

Most recently, the Tax Reform Act of 1986 (TRA) made the alternative minimum tax applicable to interest earned on newly issued private-purpose bonds and placed a single state-by-state limit on the volume of new issues of IDBs, student loan bonds, and housing and redevelopment bonds. The new state volume limits, which are more restrictive than prior law limits, are the greater of $50 per resident or $150 million a year. Bonds for publicly owned airports, ports, and solid waste disposal facilities, and for nonprofit 501(c)(3) organizations (primarily hospitals and educational institutions) are exempt from the new volume limits. With the exception of hospitals, however, nonprofit institutions may not issue bonds if they have more than $150 million in tax-exempt debt outstanding. This provision will primarily affect large universities. Tax exemption for mortgage revenue bonds and for small-issue IDBs (under $10 million) used for manufacturing facilities will terminate at the end of 1988 and 1989, respectively.

As a result of TRA, the volume of new, private-purpose bonds over the next five years will be about 20 percent less than it would have been under previous law. But while current law limits the growth of new issues, it does not end it--or the continued loss of federal revenues. If the Congress were to eliminate tax exemption for all new issues of private-purpose bonds, revenue gains would be about $3 billion in 1989 through 1993, assuming that at least some construction of airports, and sewage and solid waste facilities would qualify for tax-exempt financing as government facilities. Eliminating the tax exemption could result in higher construction costs for low-income housing and for nonprofit facilities, unless the Congress provided direct subsidies as a substitute.

Including all bonds for private nonprofit and quasi-public facilities in a single state volume limit and raising the limits beginning in 1989 to $75 million per capita or $200 million a year would raise about $1.4 billion in 1989 through 1993. This would curb the growth of all private-purpose bonds, without sharply reducing their use. The curb would primarily affect bond issues for non-profit hospitals, which are not included in the current cap. Advoates of limiting or eliminating these bonds question the need for any subsidy when the supply of hospital beds seems to be adequate; opponents point out that such limitations will raise health care costs. Bonds for airport facilities for the exclusive private use of airlines under long-term leases, such as departure gates, would also be curtailed, but public airport facilities, such as runways and control towers, could continue to be financed with the tax-exempt bonds as government facilities.

REV-09 FURTHER RESTRICT DEDUCTIONS FOR BUSINESS MEALS AND ENTERTAINMENT

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Disallow Deductions for Half of Business Meal and Entertainment Expenses	0.9	3.1	4.5	4.8	5.1	18.4

The tax code generally does not allow deductions for personal living costs, but it allows full deductions for ordinary and necessary business expenses (except for most expenses paid by employees). Deductions for business meals, entertainment, and travel expenses are restricted: taxpayers are required to show that the expenses are related to business purposes, the portion of expenses that is "lavish and extravagant under the circumstances" is disallowed, and the deductions are limited to 80 percent of expenses. The Congress imposed these restrictions because of concerns that some taxpayers are able to deduct personal living expenses undertaken in the guise of business purposes. Even when connected with a taxpayer's business, expenditures for items such as parties, meals, tickets to theater and sports events, and country-club dues provide substantial personal benefit to the taxpayer and other recipients. Deductibility of these expenses provides a tax subsidy for these forms of consumption that is not available to those who make meal, entertainment, and travel purchases outside a business setting. This tax subsidy could be further reduced by lowering the 80 percent limit. For example, imposing a 50 percent limit would raise revenues by about $18 billion in 1989 through 1993.

The choice of a dividing line between the component of entertainment that represents ordinary and necessary business expenses and the part that represents personal consumption is necessarily arbitrary; some might regard 50 percent as too stringent a standard. In addition, the proposal could have negative effects on some restaurants and on the professional sports and entertainment industries because business customers provide them with a large fraction of their income.

For example, about one-third of all baseball tickets and one-half of all hockey tickets are purchased by business firms.

REV-10 TAX CAPITAL GAINS AT DEATH

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Tax Gains at Death	a/	4.8	5.1	5.4	5.8	21.1
Enact Carryover Basis	a/	0.8	1.0	1.2	1.4	4.6

a. Less than $50 million.

Capital gains are taxed as income when realized, usually when the appreciated asset is sold. When a person sells an inherited asset, however, only the gain accrued after the date of inheritance is included in taxable income. The rest of the gain is never taxed under the income tax. The estate of the donor may be taxed on the bequest under the separate estate and gift tax, but few estates pay this tax because it generally applies only to estates whose value exceeds $600,000. Taxing capital gains on the decedent's final income tax return would raise about $21 billion in 1989 through 1993. (Under current law, the giving of a gift does not cause capital gains to be realized. If this is not changed, taxation of gains could encourage the giving of appreciated assets before death. In that case, the tax would not be paid until the beneficiary sells the appreciated asset.)

Taxing gains at death would reduce the opportunity for wealthy families to avoid tax permanently on an important source of their income. It would also reduce the tax incentive for investors to hold assets until death. This incentive was strengthened by the Tax Reform Act of 1986, which raised the tax rates on capital gains realized before death. This rise, combined with recent reductions in the estate and gift tax, may increase significantly the amount of capital gains held until death to escape taxation.

The major arguments against taxing gains at death are that it would reduce the incentive to save by raising the expected value of future capital gains taxes, and also might force small farms or businesses to liquidate assets in order to pay the tax. This latter problem could be reduced by allowing generous averaging provisions and deferral of tax payments.

As an alternative to taxing gains at death, an heir could be made to carry over the decedent's cost basis, meaning that the heir would be taxable on all untaxed gain when the asset is sold. This requirement would avoid the liquidity problem mentioned above, because carryover basis allows a continued tax deferral on the unrealized gain for heirs. Enacting carryover-basis provisions would raise about $5 billion in 1989 through 1993. The Congress enacted carryover basis for assets transferred at death in the Tax Reform Act of 1976, but this provision was postponed for three years in the Revenue Act of 1978, and was repealed in 1980. One of the chief objections to the provision was that it could be difficult for estate administrators and heirs to determine the decedent's basis. Establishing a decedent's basis would also be a problem if gains were taxed at death. This problem would result in part from the fact that the provision would require new documentation not previously needed to comply with tax law. It might be lessened over time as taxpayers begin to take the provision into account when planning their estates.

Carryover basis would also require estate administrators to allocate the basis of assets when an asset passes to more than one heir. This allocation would not be necessary if gains were taxed at death.

REV-11 TAX 30 PERCENT OF CAPITAL GAINS FROM HOME SALES

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Addition to CBO Baseline	1.3	5.4	6.0	6.7	7.5	26.9

Capital gains on most assets are taxed as ordinary income at the time an asset is sold. Capital gains on home sales, however, generally escape taxation. The tax on the capital gain from the sale of a principal residence is deferred if the seller purchases another home of at least equal value within two years. If the taxpayer dies before paying tax on the gain, this tax is never owed. Further, taxpayers aged 55 and over are allowed one opportunity to exclude up to $125,000 of gain from a home sale even if another home of equal or greater value is not purchased within two years. If the above provisions were replaced with a tax on 30 percent of capital gains from home sales, about $27 billion could be raised in 1989 through 1993.

The preferential treatment of capital gains from home sales is only one of the ways that the tax code strongly favors owner-occupied homes over other investments (for discussion of other tax preferences for owner-occupied homes, see REV-14). All of these tax preferences divert saving from more productive investments into housing. One way to make the tax treatment of housing more like that of other assets would be to replace the capital gains deferral and exclusion provisions with a small tax on gains from home sales. If 30 percent of the gain from home sales were included in taxable income, the tax would be no more than 10 percent for taxpayers facing a 33 percent marginal tax rate, no more than 8.4 percent for those subject to the 28 percent marginal tax bracket, and no more than 4.5 percent for those in the 15 percent bracket.

A tax on gains from home sales would discourage home sales, just as current law provides an incentive for taxpayers to hold, rather than sell, other capital assets. The economic losses caused by this "lock-in" effect might be more serious in the case of home sales than for other assets, especially if families were discouraged from relocating to change jobs. The tax might also deter some homeowners (especially older taxpayers with large accrued gains) from changing homes as family requirements change.

Opponents of the tax also argue that a portion of gains from home sales are attributable to inflation and should not be taxed; this problem could be avoided with an explicit adjustment for inflation. The tax is also criticized because it would tend to lower the market values of existing homes, and homes are the principal asset for most middle-class families. Finally, opponents argue that the incentive to over-invest in housing could be lessened without taxing gains on owner-occupied homes. For example, a limit on the mortgage interest deduction would lessen this incentive, but would not create a lock-in effect or tax inflationary gains.

REV-12 DECREASE LIMITS ON CONTRIBUTIONS TO QUALIFIED PENSION AND PROFIT-SHARING PLANS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Lower Limits for Defined Benefit Plans to the Social Security Wage Base (with Equivalent Reductions for Defined Contribution Plans)	0.9	2.5	2.8	3.2	3.6	12.9
Decrease the Limit for Deferrals in Salary Reduction Plans to $4,000	0.2	0.4	0.5	0.5	0.6	2.2

Saving for retirement through employer-provided qualified pension and profit-sharing plans provides two tax advantages: the investment income earned within qualified plans is effectively not taxed, and most deposits to qualified plans are not taxed until they are distributed in retirement, when some taxpayers face a lower tax rate than when they were working.

Decrease Limits on Employer Contributions. Retirement payments from defined contribution plans depend on annual contributions, usually expressed as a percentage of the employee's annual earnings, while defined benefit plans specify the pension to be received, usually expressed as a percentage of pre-retirement earnings. Currently, contributions to defined contribution plans are limited to the lesser of 25 percent of compensation or $30,000 per employee. Contributions to defined benefit plans are limited to amounts that will result in annual benefits for pensions that begin at age 65 of the lesser of 100 percent of wages or $98,600 (estimated for 1989). For pensions that begin at an earlier age, this limit is reduced on an actuarial basis. When an employee is eligible for payments from both types of plans sponsored by the same employer, a combined limit applies--the lesser of 140 percent of wages or $123,200 (estimated for 1989).

These funding limits are far higher than the pre-retirement earnings of most workers. Only one-half of 1 percent of employees earn more than $123,200 a year. Many analysts have questioned the need to subsidize such high levels of retirement income. They note further that many workers (especially in the lower half of the income distribution) are not covered by qualified plans and thus do not have access to these subsidies for retirement saving.

If the dollar funding limits for defined benefit plans were lowered to the Social Security wage base (projected to be $46,500 in 1989), with equivalent reductions in limits for defined contribution plans, the limits would still be higher than the earnings of all but about 7 percent of earners. Lowering the limit to $46,500 for defined benefit plans and $15,500 for defined contribution plans in 1989 would raise about $13 billion in 1989 through 1993. Alternatively, the limits could be lowered to amounts between current law and the Social Security wage base. For example, limits of $73,000 and $24,333 in 1989 would raise about $3 billion over five years, and would exceed the earnings of all but about 2 percent of earners.

The principal argument against reducing funding limits is that it would make participation less attractive to high-income business owners and top managers, and thus might discourage them from sponsoring these plans both for themselves and for their employees.

Change Salary Reduction Arrangements. Most salary reduction arrangements are part of employer-sponsored profit-sharing plans that allow employees to choose to receive lower current (taxable) compensation and to defer the remainder of compensation as a contribution to the plan. These arrangements typically are called 401(k) plans after the provision of the tax code that authorizes them. Similar arrangements are possible for workers in the nonprofit sector (so-called 403(b) tax-sheltered annuities), for federal workers, and for workers enrolled in some Simplified Employer Plans (SEPs).

The Tax Reform Act of 1986 capped employee deferrals for 1987 in salary reduction arrangements to no more than $7,000 in the case of

401(k) plans, SEPs, and the federal plan, and to no more than $9,500 for 403(b) tax-sheltered annuities. The $7,000 limit is indexed for inflation starting in 1988 and is estimated to reach $7,700 by 1989. If elective deferrals in all salary reduction arrangements were limited to $4,000 in 1989, about $2 billion would be raised in 1989 through 1993.

Many people question whether the tax advantages associated with salary reduction arrangements are equitably distributed, because elective deferrals are used disproportionately by high-income employees with discretionary income. Others argue that the incentive of before-tax savings for employees fails to increase retirement saving because those who choose to make elective deferrals would probably save for their retirement even without this tax advantage.

On the other hand, salary reduction arrangements are attractive to employers because they are easier to administer than traditional retirement plans. This may encourage employers to extend the advantages of qualified plans to the half of the labor force not now covered. Also, the 1986 act changed the nondiscrimination rules for salary reduction and similar plans so that employers would distribute the benefits more evenly between highly compensated workers and others.

REV-13 PHASE OUT THE CHILD- AND DEPENDENT-CARE CREDIT

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Phaseout Starting at						
$30,000	0.2	1.4	1.6	1.8	2.0	6.9
$50,000	0.1	0.5	0.7	0.8	0.9	3.0
$65,000	a/	0.2	0.3	0.4	0.5	1.5

a. Less than $50 million.

Taxpayers who incur employment-related expenses for the care of children under age 15 and certain other dependents may claim a tax credit. The credit per dollar of allowed expenses declines from 30 percent for taxpayers with adjusted gross incomes (AGI) of $10,000 or less to 20 percent for taxpayers with AGI above $28,000. Creditable expenses are limited to $2,400 for one child and $4,800 for two or more, and cannot exceed the earnings of the taxpayer or, in the case of a couple, the earnings of the spouse with lower earnings. In 1985, about $3 billion in credits were claimed on 8 million tax returns.

The tax code first recognized work-related child care costs in 1954, when an itemized deduction of up to $600 was allowed for all single taxpayers and for lower-income couples when both worked. In 1976, the deduction was converted to a 20 percent credit and the income limitations were removed. In 1981, the credit was raised to 30 percent for the lowest-income taxpayers. Beginning in 1988, expenses for overnight camps are ineligible for the credit.

Some people view the credit as a tax subsidy intended to encourage workers to provide adequate dependent care. The cost of this subsidy can be reduced by targeting it more narrowly on families who otherwise would have difficulty affording adequate care. One way to target the subsidy would be to reduce the credit percentage as incomes rise. For example, the credit percentage could be reduced by one percentage point for each $1,500 of AGI over $30,000. This option would raise about $7 billion in 1989 through 1993. It would reduce the credit for about 40 percent of families that would be able to claim the credit under current law and would eliminate it for an additional 15 percent of claimants (families with AGI over $58,500). Alternatively, phasing out the credit between $50,000 and $78,500 would raise about $3 billion in the same period; this option would reduce credits for about 20 percent of claimants and eliminate it for another 5 percent. Finally, phasing out the credit between $65,000 and $93,500 would raise $1.5 billion in the same period. This would reduce credits for 8 percent of claimants and eliminate it for another 3 percent. This third alternative was included in the Family Welfare Reform Act of 1987, passed by the House.

Opponents of reducing the credit argue that it is not a subsidy. Instead, they view it as needed for horizontal equity: parents who pay for child care in order to work are less well off, and therefore should pay less tax than taxpayers with the same income who either have no children or have one spouse at home. Phasing out the credit also could be criticized because it would raise the marginal tax rate for taxpayers with incomes in the credit phaseout range, which could discourage some secondary wage earners from working. For taxpayers with incomes in the phaseout range who claim the full credit, these proposals could raise marginal tax rates by 3.2 percentage points.

REV-14 LIMIT MORTGAGE INTEREST DEDUCTIONS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Limit Deductions to $12,000 per Return (Single) or $20,000 (Joint)	0.6	1.8	2.2	2.6	3.1	10.3
Limit Value of Deductions to 15 Percent	3.9	11.4	12.4	13.4	14.5	55.6
Phase Out Deductions for Second Homes	0.2	0.5	0.5	0.5	0.6	2.3

A home is both the largest consumer purchase and the main investment for most Americans. The tax code has historically treated homes more favorably than other investments by allowing homeowners to deduct mortgage interest expenses even though homes do not produce taxable income, and by exempting most capital gains from home sales (see REV-11). This preferential treatment has been defended because it encourages home ownership and home improvement, which can improve neighborhoods for all residents. The Tax Reform Act of 1986 (TRA) preserves the deductibility of mortgage interest on first and second homes, but phases out the deductibility of other consumer interest by 1990, and limits the extent to which interest deductions for carrying other assets can exceed income from assets.

One way for taxpayers to circumvent the limits on consumer and investment interest deductions is to finance consumer purchases and assets with home-equity loans. TRA tried to restrict this recharacterization of interest deductions by limiting the amount of home-equity debt that qualifies for home mortgage interest deductions: qualified home debt was limited to loans used for home purchase and improvements, and for medical and educational expenses. The Omnibus Budget Reconciliation Act of 1987 replaced these limits with two others. It limits for the first time debt to acquire and improve first and second homes to $1 million. Further, the 1987 act limits home-equity loans for all other purposes to $100,000.

These limits are criticized for several reasons. The amounts are so high that the tax code still provides a generous subsidy for relatively expensive homes. Further, only taxpayers who are fortunate enough to have substantial home equity are allowed to circumvent the limits on consumer and investment interest. For example, many homeowners will be able to deduct interest on home-equity loans used to finance autos while renters will not be able to deduct interest on auto loans. In addition, some find it unfair that the same limits apply to single taxpayers as to larger households.

About $10 billion in revenues could be raised in 1989 through 1993 by capping the mortgage interest deduction at $12,000 per tax return ($20,000 for a joint return and $10,000 for married couples who file separately). This option would affect less than one-half of one percent of taxpayers. It would retain the basic incentive for home ownership but would not subsidize the luxury component of the most expensive homes and vacation homes. Because the caps are higher than the deductions now taken by virtually all taxpayers, they would cause a minimum of disruption to home prices and homebuilding.

The high interest deduction currently allowed, along with the other tax advantages accorded to owner-occupied housing, shifts investment into homes and away from less subsidized investment in businesses. This shift contributes to a relatively low rate of personal saving and investment in business assets in the United States compared with other developed countries that do not allow such large mortgage and consumer interest deductions. Currently, about one-third of national investment goes into owner-occupied housing, so even a modest shift of investment to other sectors could have important effects. If the caps were not indexed for inflation, they would affect more homeowners over time. The gradual phasing down of the real value of the deduction with inflation would cushion the effects on current homeowners and the homebuilding industry, while encouraging a shift to more productive activities.

Opponents of the interest caps point out that their effects would be highly uneven across the country. In the high-priced markets of many large cities the caps would affect many upper-middle income homeowners while in most other areas they would affect only those with the most luxurious homes. Further, in periods of high interest rates, recent homebuyers and those with adjustable-rate mortgages could find themselves affected by the limits while longer-term owners with fixed-rate mortgages would not be.

Another way to reduce the tax subsidy for upper-income taxpayers would be to limit the tax savings from the current deduction to 15 percent of interest paid, the value of the deduction to those in the lowest tax bracket. This limit would increase revenue by about $56 billion in 1989 through 1993. It would affect about half of the taxpayers that use the mortgage interest deduction and therefore would probably cause some home values to decline.

A final option would be to limit the deductibility of interest on debt to acquire and improve a primary residence, plus $100,000 of other debt secured by that home. This would require interest deductions for second homes to qualify under the $100,000 interest limit on home-equity loans. Most second homes are vacation homes, and some people argue that nearly unlimited borrowing for such a luxury is inappropriate when the deductibility of interest on loans for education, medical expenses, and other consumer purchases is limited. Others argue that many owners and builders of vacation homes would suffer losses and resort areas would face reduced growth. This proposal would raise about $2 billion in revenues in 1989 through 1993.

REV-15 ELIMINATE OR RESTRICT DEDUCTIBILITY OF STATE AND LOCAL TAXES

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Eliminate Deductibility of State and Local Taxes	8.8	25.9	27.9	29.9	32.1	124.6
Maintain Deductibility of Taxes Above Floor of 1 Percent of AGI	1.5	4.5	4.8	5.2	5.6	21.6
Prohibit Deductibility of Taxes Above Ceiling of 7.5 Percent of AGI	1.5	4.5	4.8	5.1	5.4	21.2

Under current law, taxpayers may deduct state and local income, real estate, and personal property taxes from their adjusted gross income (AGI). These deductions will reduce income tax payments to the federal government by about $140 billion in 1989 through 1993.

The deductions mean, in effect, that itemizers pay state and local taxes at lower, or subsidized, rates than do nonitemizers. This may cause itemizers to support higher levels of state and local services than they would otherwise; to the extent that this is true, the deductions may indirectly increase state and local spending at the expense of federal revenues. The Tax Reform Act of 1986 reduced the subsidy to state and local governments directly, by repealing the deduction for state and local sales taxes, and indirectly, by increasing the standard deduction and lowering marginal rates, thus reducing both the number of itemizers and the value of the deductions.

Deductibility of state and local taxes has drawn criticism on several grounds. First, the deductions reduce federal tax liability only for itemizers and, because the value of an additional dollar of deductions increases with the marginal tax rate, the deductions are worth more to higher-bracket taxpayers. Second, deductibility favors wealthier communities; the higher the income level in a community, the more itemizers it will have, and thus the greater the likelihood that residents of the community will support a higher level of spending. Third, deductibility may discourage states and localities from financing services with non-deductible user fees, thus discouraging efficient pricing of some services.

Supporters of deductibility argue that it is needed to recognize differences in taxpayers' ability to pay federal income tax: they argue that a taxpayer with a large state and local tax liability will have less ability to pay federal taxes than one with equal total income and a smaller state and local tax bill. However, a taxpayer who pays higher state and local taxes may also receive more benefits from publicly provided services. In this case, the taxes are more like other payments for goods and services, and hence should not be deductible.

Supporters of deductibility also note that any higher public expenditures resulting from deductibility benefit all members of a community, including lower-income nonitemizers who do not receive a direct tax saving. Increased spending on such public goods as education, transportation, and pollution control may also have spillover benefits for residents outside the taxing jurisdiction. Further, now that direct federal subsidies such as revenue sharing have been virtually eliminated, deductibility may be needed more.

Limiting the value of the state and local deduction could raise significant revenues. Eliminating deductibility would raise about $125 billion in in 1989 through 1993. In its consideration of tax reform, however, the Congress chose to continue deductibility. Most of the incentive effect of the present deductions on public spending could be preserved if the deductions were permitted only for state and local tax payments above a fixed percentage of AGI. The average itemizer's state and local tax deductions exceed 1 percent of AGI in every state. If the floor were set at 1 percent, revenues in 1989 through 1993 would increase by about $22 billion. Another alternative would be to prohibit deductions above a fixed ceiling, which also might be a percentage of AGI. A ceiling set at 7.5 percent of AGI would increase revenues by about $21 billion in 1989 through 1993. A floor and a ceiling would have very different effects on incentives: with a floor, the incentive for increased state and local spending would remain; with a ceiling, the incentive would be reduced.

REV-16 INCREASE TAXATION OF SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Current Law Thresholds						
Tax 60 Percent of Benefits	0.2	0.8	1.0	1.1	1.3	4.4
Tax 85 Percent of Benefits	0.9	3.0	3.5	4.0	4.5	15.9
No Thresholds						
Tax 50 Percent of Benefits	2.0	6.9	7.3	7.7	8.0	32.0
Tax 60 Percent of Benefits	2.8	9.4	10.0	10.6	11.3	44.0
Tax 85 Percent of Benefits	4.6	15.6	16.9	18.3	19.6	75.0

Social Security and Railroad Retirement (Tier I) benefits constitute the federal government's largest entitlement commitment. These benefits could be reduced directly through changes in the benefit formula (see ENT-23 and ENT-24) or cost-of-living adjustments (see ENT-21 and ENT-22), or indirectly by further using the income tax to decrease the net value of benefits paid to recipients with other income. For the same reduction in the federal deficit, increased benefit taxation would concentrate the burden more on higher-income households than would, for example, a cost-of-living adjustment (COLA) freeze, where the burden would also fall on lower-income households whose principal income source is Social Security. Many argue that increased benefit taxation is, therefore, a preferable way to achieve a given target of deficit reduction among the elderly and disabled.

On the other hand, some alternatives for increased benefit taxation would lower the disposable incomes of one-half or more of today's elderly. This reduction could be regarded as a violation of long-held understandings about the implicit promises in the Social Security and Railroad Retirement programs during the time these people were working and paying their payroll taxes. In addition, taxing up to 50 percent of benefits under current law already has decreased the rate of return that today's high-wage workers will receive in Social Security; taxing a higher percentage would decrease their rate of return even further, thereby possibly eroding support for the program.

The 1983 Social Security Amendments made Social Security and Tier I benefits partially taxable to higher-income households. Under current law, adjusted gross income (AGI) includes the lesser of one-half of Social Security and Tier I benefits, or one-half the excess of the taxpayer's combined income (AGI plus nontaxable interest income plus one-half of Social Security and Tier I benefits) over a threshold amount. The threshold amount is $25,000 for single returns and $32,000 for joint returns. Because these thresholds are not indexed, a growing percentage of recipient households will be affected by this 1983 provision.

In the immediate future, taxation of Social Security and Tier I benefits could be increased by reducing or eliminating the thresholds, or by raising the fraction of benefits included in AGI.

Eliminate or Reduce the Thresholds. The tax code protects lower-income elderly households from income taxation through personal exemptions, the regular standard deduction, and an additional standard deduction for the elderly. Even if the benefit taxation thresholds were eliminated, these other provisions would still prevent 46 percent of recipient households from having to pay any taxes on the one-half of Social Security and Tier I benefits that would then be fully includable in AGI. The thresholds currently allow another 45 percent of recipient households to pay less taxes than other households with comparable incomes. Eliminating the thresholds would remove a tax preference that is not well targeted on those with lower incomes and would reduce tax disparities among middle-income households. In addition, for a comparable deficit reduction of $32 billion in 1989 through 1993, including a full 50 percent of benefits in AGI would have smaller effects on the disposable incomes of the lower- income elderly than curtailing cost-of-living increases or similar measures.

On the other hand, complete elimination of the thresholds with no other changes would decrease the disposable incomes of today's elderly with incomes below the median, while leaving upper-income elderly unaffected. To minimize the effects on moderate-income recipients, the thresholds instead could be lowered--for example, to $12,000 for single filers and $18,000 for joint returns. With up to 50 percent of benefits includable in AGI, these lower thresholds would raise about $15 billion in 1989 through 1993, an amount that is roughly half of what would be generated by including 50 percent with no thresholds.

Increase Fraction of Benefits Included in AGI. Under current law, employers pay one-half of workers' combined payroll taxes from before-tax income. Accordingly, many people reason that one-half of Social Security and Tier I benefits are properly includable in AGI. A competing view is that these benefits should be taxed more like public employee pensions and those few private-sector pensions in which individuals make contributions from after-tax income. Under current law, a fraction of benefits from contributory pension plans is excluded from tax. This fraction, called the exclusion ratio, is attributable to the nominal amount of after-tax contributions. The remaining share of these benefits is fully taxable. A third view is that the current tax treatment of contributory pensions--and, by extension, Social Security and Tier I--should be changed to allow retirees to recover tax-free the amount of their after-tax contributions adjusted for inflation. However, under current tax law, no such inflation adjustments are made for a taxpayer's investments from after-tax income in pensions, capital assets, or other holdings.

Because the ratio of after-tax contributions (the employee share of payroll taxes) to Social Security and Tier I benefits varies by each worker's earnings history and marital status, no single exclusion ratio is correct for all beneficiaries. Requiring the Social Security Administration to calculate separate exclusion ratios for each beneficiary, however, would be administratively burdensome. A 15 percent exclusion ratio--that is, including up to 85 percent of benefits in AGI--would make the tax treatment of Social Security for workers with high earnings roughly comparable to that afforded contributory pensions under current law, and would be more generous for those with lower earnings. Depending on long-term inflation assumptions, an inflation-adjusted exclusion ratio along the same lines falls between 30 percent and 40 percent; this would mean including up to 60 percent or 70 percent of benefits in AGI. For example, including up to 60 percent of benefits in AGI with current thresholds would raise about $4 billion in 1989 through 1993, and about $44 billion in the same period if the thresholds are eliminated. (For more discussion of alternative exclusion ratios, see Congressional Budget Office, "An Analysis of Alternatives for Taxing Social Security as a Private Pension," Staff Working Paper, June 1985, revision in process.)

If current law thresholds were maintained, about $16 billion would be raised in 1989 through 1993 from the top 18 percent of recipient households by increasing includable benefits to 85 percent. With thresholds of $12,000 and $18,000 and up to 60 percent of benefits includible in AGI, approximately $23 billion would be raised over the same period. With these lower thresholds and up to 85 percent of benefits includable in AGI, approximately $42 billion would be raised over the period.

REV-17 TAX THE INCOME-REPLACEMENT PORTION OF WORKERS' COMPENSATION AND BLACK LUNG BENEFITS

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Addition to CBO Baseline	0.7	2.4	2.6	2.7	2.9	11.3

Under current law, unemployment benefits are fully taxable and Social Security and Railroad Retirement (Tier I) benefits are partially taxable to upper-income households. Other entitlement benefits are not taxable. Many of these benefits, such as Aid to Families with Dependent Children (AFDC), are means-tested. Revenue gains from making such benefits taxable would be extremely small because few people who qualify for these programs would have enough income to incur any income tax liability. However, revenues could be raised by taxing the portion of Workers' Compensation and Black Lung benefits that replaces income lost as the result of work-related injuries or Black Lung disease. The share of these benefits that reimburses employees for medical costs is about 30 percent. Including the income-replacement portion of these benefits in AGI would add about $11 billion to revenues in 1989 through 1993.

Taxing the income-replacement portion of Workers' Compensation and Black Lung benefits would make the tax treatment of these entitlement benefits comparable to the treatment of unemployment benefits and to the treatment of the employment income that these benefits replace. It would also improve work incentives for disabled workers who are able to return to work: under current law, the after-tax value of the wages they are able to earn may be less than the tax-free benefits they receive while disabled.

Opponents of taxing these benefits note that legal or insurance settlements for nonwork-related injuries are not taxable, even if a portion of them reimburses for income loss, and that taxation of workers' compensation benefits would therefore treat these two types of compensation inconsistently.

REV-18 TAX NONRETIREMENT FRINGE BENEFITS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Tax Some Health Insurance Premiums			(See ENT-13)			
Tax Life Insurance Premiums						
Income tax	1.2	1.9	2.0	2.1	2.2	9.4
Payroll tax a/	0.6	0.8	1.0	1.0	1.1	4.5
Impose a 3 Percent Excise Tax on the Value of Nonretirement Fringes	2.6	3.9	4.2	4.6	4.9	20.2

a. Estimates are net of reduced income tax revenues.

Employee compensation is taxable unless the tax code contains an explicit exception. Such exceptions apply to most employer-paid nonretirement fringe benefits, which are excluded from the income and payroll tax bases even though they constitute current compensation to employees. This exclusion reduces revenues substantially. For employer-paid health and life insurance premiums alone, the revenue loss will be about $25 billion in income tax revenues and about $16 billion in payroll tax revenues in 1989.

In addition to employer-provided health and life insurance, the law explicitly excludes from gross income employer-paid dependent care and miscellaneous benefits, such as employee discounts, parking, and athletic facilities. (The exclusion of legal service plans and educational assistance benefits expired on December 31, 1987.)

The exclusions can be opposed on the basis of both efficiency and equity. They are inefficient to the extent that employees bargain for tax- free benefits that they would not be willing to purchase out of after-tax income. Increased demand for the tax-free services leads, in turn, to higher prices for the services. For example, employer-paid health insurance plans may have contributed to the strong growth in demand for health care, which may have contributed to recent sharp rises in health care costs. The higher prices are paid by all who need health care, not just recipients of tax-free insurance.

The exclusions are viewed as unfair because a taxpayer receiving no fringe benefits pays more tax than another with the same total income but a larger share in the form of fringe benefits. Further, the benefits of the exclusion are greater for those with higher incomes because they face higher marginal tax rates and because fringe benefits are rarely provided for low-wage workers.

Making all fringe benefits taxable presents problems in evaluating those benefits and in assigning the value to individual employees. Few valuation problems arise when the employer purchases goods or services and provides them to employees, but it is more difficult to determine the value of a facility, such as a parking lot, provided by the employer. Further difficulties arise if the total value of the fringe benefits needs to be assigned to individual employees. In cases where the employer provides a service, such as day care, it might be considered unfair to assign the same value to all employees regardless of their level of use; however, it could be administratively complex to assign values that depend on each worker's use. Further, the costs of collecting taxes on small fringe benefits (such as employee discounts) could exceed the revenue collected.

The per-employee value of employer-paid health and life insurance is relatively easy to determine. The premiums paid for each employee could be reported on the employee's W-2 form, and withholding computed as it is for other taxable income, as is already done for some life insurance premiums (see below). The measurement of insurance values would be more difficult when benefits are provided directly, as when employers provide medical care or reimburse employees for medical costs incurred (under self-insurance plans).

One way to tax all nonretirement fringe benefits would be to impose the tax on employers, based on the total cost of the fringe benefits provided, rather than on employees. Determining the total cost of fringe benefits would present some difficulties. This option would, however, eliminate the need to assign the value of fringe benefits to individual employees.

Tax Some Employer-Paid Health Insurance Premiums. Health insurance premiums were made subject to nondiscrimination rules for the first time in the Tax Reform Act of 1986. These rules limit the extent to which employer-paid health plans may favor higher-paid workers. Still, the present exclusion for employer-paid health insurance premiums has been criticized as unfair to those who must pay for their health insurance with after-tax dollars. The self-employed can exclude only 25 percent of their health insurance costs now, and none of them after 1989; and taxpayers who pay for their own health insurance can deduct the cost of their insurance only if their total medical expenses exceed 7.5 percent of their adjusted gross income. Two proposals to tax some employer-paid health insurance premiums are described above (see ENT-13).

Tax Employer-Paid Life Insurance Premiums. Employer-paid group term life insurance premiums are currently excluded from taxable income, but the exclusion is limited to the cost of the first $50,000 of insurance, and nondiscrimination rules apply. The Omnibus Budget Reconciliation Act of 1987 made the part of life insurance premiums that is taxable under the income tax also taxable under the payroll tax. The exclusion is not available to the self-employed. Making all employer-paid premiums taxable would add about $9 billion to income-tax revenues and about $5 billion to payroll-tax revenues in 1989 through 1993.

A difficulty with this tax option arises because many employers provide death benefits under pension plans as substitutes for life insurance. Employer contributions to pension plans are income-tax-deferred (and the first $5,000 of death benefits paid are tax-exempt) and are exempt from the payroll tax. If employer-paid life insurance plans were made taxable, employers might choose to offer less life insurance and larger pension plan death benefits instead.

Impose an Excise Tax on the Value of Nonretirement Fringe Benefits. An alternative to including employer-provided benefits in the income of recipients would be to impose an excise tax on specific benefits, to be paid by employers. These benefits would include the full employer's share of health insurance, premiums to fund the first $50,000 of life insurance, dependent care, parking, athletic facilities, and employee discounts. A tax imposed at a 3 percent rate, for example, would raise about $20 billion in 1989 through 1993. The bulk of these revenues would come from taxing employer-paid health insurance. Under this option, employers would need to know only their total fringe benefit costs; they would not have to value the benefits paid to each employee. This tax would maintain most of the incentives for employers to provide fringe benefits instead of taxable wages because the 3 percent excise tax rate would be much lower than the tax rate on wages.

This tax could be criticized as unfair for two reasons: the tax rate would not rise with the income of employees, as it would if the benefits were taxed under the income tax; and the tax might result in lower taxable wages for all employees, regardless of the benefits each receives. However, the degree of the inequity would be small as long as the tax were imposed at a low rate.

REV-19 EXPAND SOCIAL SECURITY COVERAGE

Addition to CBO Baseline a/	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Extend HI Coverage to State and Local Government Employees Not Now Covered	1.3	1.9	1.9	2.0	2.0	9.0
Extend OASDI Coverage to New State and Local Government Employees	0.2	1.0	1.6	2.3	3.0	8.2

a. These estimates do not include the effect of any increases in benefit payments that would result from this option. These would be small over this five-year period. Estimates are net of reduced income tax revenues.

In the past, government workers were not required to pay Social Security payroll taxes. Beginning in 1982, legislation made Social Security taxes mandatory for certain groups of government workers. All federal workers were required to contribute to Medicare Hospital Insurance (HI) beginning in 1983. New federal employees were required to contribute to the Old-Age, Survivors, and Disability Insurance (OASDI) trust funds starting in 1984. In 1986, HI taxes were made mandatory for all new employees of state and local governments (those hired after March 31, 1986).

Coverage under the HI and OASDI programs could be expanded to include more state and local employees. Under current law, many of these employees will qualify for benefits when they retire based on other employment in covered jobs or their spouses' employment. Thus, these workers will receive benefits in return for a smaller amount of lifetime payroll taxes than is paid by those who work continuously in covered employment. This is especially true for HI benefits: about 90 percent of retired state and local workers receive benefits, but only about 70 percent worked in a covered state and local job. Inequitable treatment is less of a problem for OASDI benefits, because these benefits are reduced for retired government workers who have worked a substantial portion of their careers in employment not covered by Social Security.

As more workers pay OASDI and HI payroll taxes, the government's liability for future program benefits will grow. However, expanding HI coverage would have a small effect on future benefit payments--as noted above, most state and local workers are already able to claim HI benefits upon retirement. Expanding OASDI coverage would raise future benefits more significantly, but the added payroll tax revenue would exceed any added benefits for many years to come. Thus, these two tax options would reduce the deficit even when the added benefits are taken into account, and even in the longer term.

State and local governments would be required to pay the employer share of HI and OASDI taxes for their newly covered workers. Costs for states that currently have few covered workers would be higher than for states that have already elected to include many of their employees in the OASDI and HI programs.

Extend HI Coverage to State and Local Employees Not Now Covered. State and local government employees hired on or before March 31, 1986 are the only group for which HI coverage is not mandatory. A proposal to extend HI to these employees, which would raise about $9 billion in 1989 through 1993, was considered during the budget reconciliation process in the last three years, and was included in the President's budget request for 1988 and 1989.

Extending OASDI Coverage to New State and Local Employees. Extending OASDI coverage to new state and local employees would raise about $8 billion in 1989 through 1993. Social Security coverage would improve the protection that many new state and local government workers and their families would have. It is easier to qualify for disability and survivors' benefits under Social Security than under many public employee benefit programs, and eligibility is not lost if the employee changes jobs. Further, for a given amount of covered wages, younger and short-service workers will receive more generous retirement benefits from Social Security than if the wages were covered solely by a public pension plan. The difference is that Social Security benefits are calculated based on indexed wages, while benefits from public pension plans are based on nominal wages.

State and local governments would have to pay the employer share of these taxes if their employees were to become covered under OASDI. Representatives of some localities argue that this would be a difficult financial burden for two reasons. First, state and local governments would have to create a separate pension plan for workers newly covered by OASDI, so that their pension benefits would not duplicate Social Security retirement benefits. Maintaining separate pension plans could be administratively complex. Second, the funding for current state and local pension plans might be inadequate for governments operating their pension plans on a pay-as-you-go basis, using current contributions to pay benefits to current retirees.

REV-20 REPEAL THE MEDICARE TAXABLE MAXIMUM

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Addition to CBO Baseline a/	2.5	7.1	7.9	8.4	9.0	34.9

a. Estimates are net of reduced income tax revenues.

Under current law, wages above the taxable maximum ($45,000 in 1988) are exempt from all payroll taxes including the Medicare Hospital Insurance (HI) tax. For workers now paying payroll taxes, only about 10 percent of wages are above the taxable maximum. About $39 billion in additional revenue would accrue to the HI trust fund in 1989 through 1993 if the taxable maximum for Medicare was repealed beginning in 1989; this would reduce the deficit by about $35 billion. This option was considered in the budget reconciliation process in 1986 and 1987.

Revenues from a repeal of the Medicare taxable maximum would help improve the solvency of the HI trust fund; the fund's trustees projected in 1987 that it will begin showing a negative cash flow in 1995 and will be exhausted by 2002. Repeal of the Medicare taxable maximum would end the current situation in which highly paid workers pay a smaller share of their wages to finance Medicare than do most workers.

Opponents of this option might argue that high-wage workers already subsidize other workers, because they pay more HI taxes yet receive the same coverage as other workers. Thus, they claim that an HI tax increase should not apply to high-wage workers alone. Increasing the HI tax rate from 1.45 percent to 1.60 percent for both employers and employees would raise about the same revenues over the five-year period as repealing the taxable maximum. Over a longer period, repealing the taxable maximum would raise more revenues.

Some people oppose any increase in HI taxes. They argue that the financial problems of the HI trust fund stem from unanticipated growth in outlays and that the solution to these problems should be sought by decreasing spending and not by increasing taxes.

REV-21 INDEX THE UNEMPLOYMENT INSURANCE TAXABLE WAGE BASE

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1989	1990	1991	1992	1993	
Addition to CBO Baseline a/	0	0.3	0.6	1.1	1.1	3.1

a. These estimates assume that the change is implemented in January 1990, to allow time for changes in state laws. Some states with Unemployment Insurance programs in good financial condition are assumed to offset at least part of the increases in the state tax base with reductions in state tax rates. Estimates are net of reduced income tax revenues.

The joint federal/state Unemployment Insurance (UI) program is financed primarily through federal and state payroll taxes on employers. The federal UI tax is imposed on the first $7,000 of wages per worker. This amount also serves as the minimum base for state UI taxes. Because the federal wage base has been increased only three times since 1940, when it was $3,000, the proportion of wages in covered employment subject to the federal tax has fallen from over 90 percent in 1940 to less than 35 percent today. The ratio of the net aggregate state trust fund balance to total wages and salaries has also fallen from 2.2 percent in 1970 to 1.0 percent in 1987.

Indexing the federal UI wage base by linking it to the change in the national average wage--as is done with the Social Security wage base--would prevent further erosion in the real wage base. Indexation would maintain the current relationship between covered wages and unemployment taxes assuming no change in state UI tax schedules. It would also preserve the current relationship between per capita tax payments and per capita benefits, because UI benefits tend to increase with nominal wages.

Indexing the wage base would increase combined federal and state UI revenues by almost 5 percent, while reducing the federal budget deficit by about $3.1 billion in 1990 through 1993. (Because both federal and state taxes are counted as revenue to the federal government, increases in both revenue sources decrease the federal budget deficit.) Federal UI tax revenues would rise nearly in proportion to future increases in the federal tax base. In contrast, aggregate state UI taxes might rise less than proportionately: states with tax bases currently higher than the federal base (about two-thirds of states) might not be affected by indexation for several years, and states that do not need additional UI revenues might choose to offset the effects of an increased wage base by reducing their tax rates. Indexation would concentrate the tax increase on the wages of workers now earning more than the current tax base; this would make the UI tax somewhat less regressive than it is now.

Opponents of indexing argue that it would result in higher labor costs in some states, which could lead to higher unemployment in those states. Moreover, incentives for state UI programs to remain solvent have increased in recent years. For example, states are now charged interest on loans from the federal UI program. Thus, states may increase their programs' solvency on their own, obviating the need for this option. Opponents also argue that the states, not the federal government, should determine whether UI taxes should be raised through an increase in the base or through higher rates.

REV-22 IMPOSE A VALUE-ADDED OR NATIONAL SALES TAX

Addition to CBO Baseline a/	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
5 Percent Rate, with Comprehensive Base	0	76.8	116.6	127.0	138.6	459.0
5 Percent Rate, with Exemptions for Food, Housing, and Medical Care	0	44.3	67.2	73.2	79.8	264.5
5 Percent Rate, with Low-Income Relief Under Means-Tested Programs b/	0	58.2	88.6	96.3	104.9	348.0

a. Estimates are based on effective date of January 1, 1990 and are net of reduced income and payroll tax revenues.

b. Includes increased outlays for Medicaid, Food Stamps, Medicare, Supplemental Security Income, and Aid to Families with Dependent Children.

A national value-added tax (VAT) could raise substantial revenue at relatively low tax rates. A VAT is typically administered by taxing the total value of sales of all firms, but allowing firms to claim a credit for taxes paid on purchases from other firms of raw materials, intermediate materials, and capital goods. Thus, firms pay tax on their wages, salaries, profits, and interest--their "value added." Because aggregate value added equals sales to final consumers, another method of taxing the same base is to impose a national retail sales tax.

A 5 percent VAT on a broadly defined consumption base (see Table 7) could reduce the deficit by about $77 billion in fiscal year 1990 and roughly $459 billion in 1989 through 1993. At the same rate, a VAT on a narrower base (see Table 7) could net about $44 billion in 1990 and over $265 billion in 1989 through 1993. These projections assume that collections would not be-gin until January 1, 1990, because the Internal Revenue Service estimates that it would take approximately 18 months after the date of enactment to begin to administer a VAT.

TABLE 7. SAMPLE CALCULATION OF A VALUE-ADDED TAX BASE, 1986

Items Included in Tax Base		Amount (In billions of dollars)
Total Personal Consumption in GNP		2,799
Less:	Rent on housing	437
	Net foreign travel expenditures	12
	Religious and welfare activities	62
Plus:	New residential construction	213
Broad VAT Tax Base		**2,501**
Possible Exclusions from the Base a/		
	New residential construction	213
	All medical care (including insurance)	359
	Food purchased for off-premises consumption (excluding alcohol beverages)	297
	Food furnished to employees	8
	Food produced for farm consumption	1
	Clothing issued to military personnel	0
	Brokerage, banking, and life insurance services	143
	Local transit (excluding taxis)	4
	Clubs and fraternal organizations	5
	Toll roads, etc.	1
	Private education and research	47
Narrower VAT Tax Base		**1,423**

SOURCE: Congressional Budget Office, based on Department of Commerce, National Income and Product Accounts.

a. The excluded amount assumes that consumption is taxed at a zero rate.

If a large amount of revenue is to be raised, a VAT might be preferable to an income-tax increase because it is theoretically neutral between present and future consumption, and therefore would not adversely affect incentives for saving and investment, as an equal increase in income taxes would. In addition, it would distort economic decisions less than would an equal-revenue increase in selective consumption taxes. The VATs that have been enacted in other countries, however, have seldom conformed to the ideal. A tax with many exceptions and multiple rates would distort consumption choices more than a broadly based VAT and could be more distorting than higher income tax rates.

The major argument used against a VAT is that it is regressive when compared with annual income: the tax per dollar of consumption is the same for all taxpayers, but the ratio of consumption to income falls for people in higher income groups. Regressiveness can also be measured by comparing the tax with annual expenditures, which vary less than annual income and may be a better indicator of long-run income. Under this measure, a VAT appears less regressive (and some forms of VAT appear proportional).

A VAT could be made less regressive by allowing exemptions for goods and services consumed by low-income people, although such exemptions would substantially increase costs of enforcement and compliance and would reduce revenues from a VAT. One alternative for offsetting regressiveness would be to allow additional exemptions or refundable credits for low-income people under the federal income tax, though this would reduce the revenue gains from the VAT and would cause many people to file tax returns who otherwise would have no need to file.

Another alternative might be to include food and medical care in the narrower tax base, but to increase payments to low-income individuals through means-tested programs such as Medicaid, Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), and Food Stamps. With medical care subjected to the VAT, Medicaid and Medicare benefits would automatically be adjusted to reflect the tax. A 5 percent increase in Food Stamp, AFDC, and SSI benefits would compensate low-income people for taxes on food, as well as partially offset taxes on other purchases. After accounting for the costs of these additional outlays, this option would reduce the deficit by about $58 billion in 1990, and about $348 billion in the years 1989 through 1993.

Other arguments against a VAT are that any one-time increase in the price level it induces might have inflationary repercussions, though this result would depend on monetary and fiscal policies, and that states would regard a federal sales tax as interfering with their traditional revenue base. In addition, the large revenue-raising potential of a federal VAT is of concern to some people who fear it might facilitate undue growth of the federal government. Finally, a federal VAT would impose administrative costs on the firms paying the tax and claiming credits, and it would require new collection and enforcement personnel and procedures. In 1984, the Treasury Department estimated that a VAT would require 20,000 additional personnel at an annual cost of about $700 million. Because the administrative and compliance costs are relatively high, some analysts argue that it would be inefficient to impose a VAT at rates below 5 percent.

REV-23 INCREASE ENERGY TAXES

Addition to CBO Baseline a/	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Impose Tax on Domestic and Imported Oil ($5 per barrel)	20.1	21.4	21.4	21.4	21.5	105.8
Impose Oil Import Fee ($5 per barrel)	7.9	8.2	8.3	8.2	8.2	40.8
Increase Motor Fuel Taxes (12 cents per gallon)	10.9	11.3	11.4	11.6	11.7	56.9
Impose Broad-Based Tax on Domestic Energy Consumption (5 percent of value)	16.3	17.8	18.9	20.3	21.6	94.8

a. These added revenues are net of estimated changes in income, windfall profit, and other taxes. Increases in federal government expenditures for energy products under these options are not estimated. The revenue estimates are based on CBO's baseline oil price forecast of $18 per barrel in 1989, rising to $23 per barrel by 1993. If oil prices differ from this forecast, revenues may be significantly affected. The effective date for all of these proposals is October 1, 1988.

Energy taxes could raise significant amounts of revenue, increase conservation by making energy more expensive, and reduce the country's dependence on foreign oil suppliers. The United States depends on foreign sources for about 40 percent of the oil it consumes, and about 20 percent of its total energy. This dependence exposes the U.S. economy to potential interruptions in energy supplies.

Energy taxes would raise energy prices and might lead to reduced energy consumption. Thus, they could help preserve recent conservation gains that might otherwise be lost because of lower world oil prices. To the extent that taxes on oil lead to reduced demand for imported oil, foreign suppliers would absorb part of the tax through lower world oil prices.

One argument against energy taxes is that they are regressive because they would absorb a larger fraction of family incomes for low-income taxpayers, who spend a higher percentage of their income on energy than do high-income families. Regressiveness can be measured against annual expenditures, instead of income; using this measure, energy taxes appear almost proportional. Whichever measure is used, the regressiveness of energy taxes would be offset somewhat if the taxes cause an increase in the Consumer Price Index that leads to higher benefits from indexed transfer programs. It also could be offset by adjustments in income tax rates and by direct energy subsidies for low-income people.

Energy taxes have been opposed on several other grounds. They could have widely different effects in different parts of the country. For example, taxes that increase the relative price of fuel oil would have the greatest impact on the Northeast, while taxes that increase the relative price of gasoline would have the greatest impact on the West. (See Congressional Budget Office, *The Budgetary and Economic Effects of Oil Taxes*, April 1986.) Further, some observers argue that stockpiling oil is a better way of relieving dependence on imports because it would not artificially reduce current energy use by households and businesses. This argument follows from a view that, aside from the problem of supply interruption, world energy prices accurately reflect real resource costs and thus already provide an appropriate incentive for energy conservation.

Excise Tax on Domestic and Imported Oil. A $5-per-barrel excise tax on all oil--both domestically produced and imported--would raise revenues by about $21 billion per year. It could increase the price of a barrel of oil by as much as 28 percent or the price of a gallon of gasoline by about 12 cents.

A tax on oil would increase the price that consumers must pay, giving them an incentive to use less oil either through conservation efforts or by switching to an alternative source of energy such as natural gas or coal. The tax would cause oil reserves to decline in value, and coal and gas reserves to increase in value. This would discourage the exploration and production of oil and would encourage the production of coal and natural gas.

An oil tax, whether on all oil or only imported oil, would raise the costs for industries that use oil as the primary production input (for example, petrochemicals and paints). It would make it more difficult for domestic companies in these industries to compete with foreign companies that would pay less for oil.

Since 1981, the average cost of a barrel of oil has dropped from about $35 to under $20. A $5-per-barrel oil tax would partially offset this price reduction and help retain incentives for energy conservation efforts and for production from alternative energy sources. The tax would still leave consumers paying significantly lower prices than seven years ago. The tax could, however, further depress the after-tax prices that suppliers of oil receive.

Oil Import Fee. As an alternative to an excise tax on all oil, the Congress could impose the tax only on imports. This type of tax was discussed during the deliberations over the budget resolutions for fiscal years 1986, 1987, and 1988. An oil import fee of $5 per barrel would raise revenues by about $8 billion per year.

An oil import fee would allow domestic suppliers to charge a higher price and still remain competitive with imports, providing an incentive to increase domestic production. Like the tax on all oil, the fee would also maintain conservation incentives by increasing energy prices. These effects would reduce U.S. dependence on foreign oil in the short term, although long-term dependence might be increased if U.S. oil supplies were depleted faster. Opponents of an oil import fee argue that the United States should take advantage of cheap foreign oil to preserve the more costly U.S. reserves for future use.

Because an oil import fee will reduce demand and prices for imported oil, some important U.S. trading partners might object to the fee (though others who are net energy importers would benefit from lower world energy prices). Exempting oil imports from selected countries such as Canada, Mexico, and the United Kingdom, however, would substantially reduce the fee's revenue potential. Imports from these countries now account for about 28 percent of U.S. oil imports.

An oil import fee would have different effects in different regions of the country. It would benefit oil-producing states, because producers would receive higher prices, but oil-consuming states--especially in the Northeast--would bear much of the burden of the tax and of the higher prices U.S. oil producers receive.

An oil import fee would cause spending for oil products to increase by 20 percent, but only a small share of this increase would result in added federal revenues. The remainder would increase the incomes of domestic oil producers. Thus, the risk of inflation relative to the revenue collected is higher than for most other selective product taxes.

Additional Motor Fuel Excise Taxes. Federal motor fuel taxes are currently 9.1 cents per gallon of gasoline and 15.1 cents per gallon of diesel fuel. The revenue from these taxes is earmarked for the federal Highway Trust Fund, which pays for construction and improvement of interstate highways, bridges, and mass transit facilities, and for the Leaking Underground Storage Tank Trust Fund. State governments also impose gasoline taxes ranging from 7 cents to 20 cents per gallon. Compared with other countries, many of which levy taxes of well over $1.00 a gallon, the United States tax rates on motor fuels are among the lowest in the world.

An additional 12-cent federal tax on motor fuels would raise revenues by about $1 billion per year for each cent per gallon of tax. Because the average national price of gasoline has dropped from a peak of about $1.39 per gallon in March 1981 to about $0.99 in October 1987, an additional tax of 12 cents per gallon would not put the total cost of gasoline above what consumers have already experienced. In order for proceeds from the additional tax to reduce the deficit, the Congress must allocate them to the general fund instead of allowing them to be used to support additional spending from the Highway Trust Fund.

The tax increase would reduce consumption of gasoline and diesel fuel by encouraging people to drive less or purchase more fuel-efficient cars and trucks. Some proponents of the tax view it as an appropriate charge for the costs of pollution and road congestion associated with automobile use. Another advantage of a motor fuel tax increase is that it would not have the same adverse effects on the international competitiveness of U.S. firms as other energy taxes. This advantage results from the fact that most gasoline and diesel fuel is used either by consumers or in the domestic transportation sector, not as an input in industrial production.

Opponents of a motor fuel tax rate increase argue that this tax would impose an unfair burden on the trucking industry and people who commute long distances by car, who are not necessarily the highway users that impose the highest costs of pollution and congestion on others. These costs are much higher in densely populated areas, primarily in the Northeast, whereas per capita consumption of motor fuel is highest in sparsely populated states, mostly in the West. Finally, a rate increase could lead to more tax evasion. Compliance with the motor fuel taxes is already a problem. It is particularly difficult to enforce the tax on diesel fuel because the same product can be sold as nontaxable home heating oil or as taxable diesel motor fuel.

Broad-Based Tax on All Energy. An alternative to selective excise taxes is a broad-based tax on all forms of energy consumption, whether produced domestically or abroad. A national energy tax would heighten conservation incentives and reduce consumption of all forms of energy. Further, because the tax would apply to all energy sources, it could raise much more revenue at a lower rate than selective taxes. The tax could be imposed as a fraction of the value of fuel, or could be based either on units produced (such as barrels of oil, tons of coal, or cubic feet of gas) or on the heat content of the fuel measured in British thermal units (Btu). Unlike a Btu or per-unit tax, a tax on energy value would not change relative fuel prices and would not encourage consumers to switch from one form of energy to another. Therefore, this type of tax would not be preferable to the other option if the objective were to decrease dependence on imported oil. A 5 percent tax on the value of all domestic and imported energy consumption, including coal, petroleum, natural gas, hydroelectricity, and nuclear power, would raise an average of $19 billion per year in revenues.

REV-24 INCREASE EXCISE TAXES

Addition to CBO Baseline a/	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Raise Cigarette Tax to 32 Cents per Pack	2.8	3.0	3.0	3.0	3.0	14.9
Increase Taxes on Distilled Spirits	0.4	0.4	0.4	0.4	0.4	2.0
Raise Taxes on Beer and Wine to Rate on Distilled Spirits	3.8	4.1	4.2	4.3	4.4	20.7
Index Current Cigarette and Alcohol Tax Rates for Inflation	0.5	0.9	1.2	1.5	1.8	5.9

a. Estimates are net of reduced income and payroll tax revenues.

Additional revenues could be raised by increasing existing federal excise taxes on tobacco and alcohol.

Increase the Cigarette Tax. The excise tax on cigarettes has been 16 cents per pack since January 1, 1983. The tax is now less than 15 percent of the current average market price (including tax) per pack, significantly less than the 42 percent of the price it represented in 1951. Doubling the current tax on October 1, 1988, would raise net revenues by about $15 billion in 1989 through 1993. Increasing the tax to 24 cents per pack would increase revenues by about $8 billion over the same period.

An increase in the cigarette tax could be seen as compensation for the costs of smoking that society ultimately bears, such as the smoking-related medical costs borne by both smokers and nonsmokers. It might also discourage smoking, especially among teenagers, by raising prices, and could result in long-run improvements in health. On the other hand, if the increase exceeded the net costs imposed on other taxpayers by smokers, it could be regarded as discriminatory against smokers (about 30 percent of the adult population). In addition, the tax is regressive: it is a higher share of the income and expenditures of low-income households than of households with higher incomes. (See Congressional Budget Office, "The Distributional Effects of an Increase in Selected Federal Excise Taxes," Staff Working Paper, January 1987.) Finally, increases in the federal cigarette tax might have an adverse effect on state and local revenues from cigarette taxes and could prevent states from increasing these taxes.

Increase Taxes on Alcoholic Beverages. The tax on distilled spirits was increased to $12.50 per proof gallon effective October 1, 1985. This was the first increase in the distilled spirits tax since 1951, when the rate was set at $10.50 per proof gallon. Even at the current rate of $12.50, the real value of the tax is much lower than it was in 1951. Increasing the tax to $15.00 per proof gallon on October 1, 1988, would raise about $2 billion in revenues in 1989 through 1993; the tax on a 750 milliliter bottle of 80 proof liquor would rise by 40 cents.

The per-unit taxes on beer and wine have not changed since 1951. Moreover, beer and (especially) wine are taxed much more lightly than distilled spirits. Increasing the taxes on beer and wine to the alcohol-equivalent of the current tax on distilled spirits, effective October 1, 1988, would raise about $21 billion in 1989 through 1993. The tax on a 750 milliliter bottle of wine would increase from 3 cents to 54 cents, and the tax on a six-pack of beer from 16 cents to 63 cents. Similarly, increasing the tax on wine to the alcohol-equivalent rate of the current tax on beer would raise $1.3 billion through 1993.

Increased taxes on alcoholic beverages would partially restore their real values, which have declined with inflation, and would help to offset the social costs of drinking (such as from alcohol-related automobile accidents). Opponents of tax increases argue that alcohol taxes are regressive when measured as a share of household incomes. The CBO study cited above indicates that these taxes now account for a slightly higher share of household income for low-income households than for those with higher incomes.

Index Cigarette and Alcohol Tax Rates for Inflation. Indexing the taxes on cigarettes and alcoholic beverages to the Consumer Price

Index would ensure that tax revenues keep pace with inflation. Indexing current cigarette and alcohol tax rates to changes in the CPI after October 1, 1988 would raise about $6 billion in revenues in 1989 through 1993. Indexing these taxes would prevent inflation-induced erosion of tax revenues in a gradual and predictable manner, thereby avoiding abrupt increases in unit rates.

An alternative to indexing would be to convert the unit taxes to *ad valorem* taxes (set as a percentage of manufacturers' prices). This method would accomplish the same objective of tying tax revenues to price increases, although revenue would be tied to the prices of the taxed goods, not the general price level. Administration of *ad valorem* taxes would be more complex than for per-unit taxes because of the need to specify manufacturers' prices when the goods are sold by manufacturer-controlled wholesalers and retailers.

REV-25 IMPOSE POLLUTION CHARGES

Addition to CBO Baseline a/	Annual Added Revenues (In billions of dollars) 1989	1990	1991	1992	1993	Cumulative Five-Year Addition
Tax SO_2 Emissions at $50 per Ton	0.6	0.8	0.9	0.9	0.9	4.1
Tax NO_x Emissions at $100 per Ton	0.5	0.8	0.8	0.8	0.8	3.6
Tax Hazardous Wastes at $5 per Ton	0.6	0.9	0.9	0.9	0.9	4.0

a. Estimates are net of reduced income and payroll tax revenues.

Revenues could be raised by taxing emissions or production of substances that damage the environment. Pollutants that could be taxed include sulfur dioxide (SO_2) and nitrogen oxides (NO_x), which may cause acid rain, and hazardous wastes.

If set at sufficiently high levels, pollution charges could be used as substitutes for current environmental regulation in reducing pollution levels. However, the charges described below are set at rates so low that they would not alter current pollution abatement levels significantly; their primary effect would be to provide new sources of government revenue instead of effective pollution control incentives.

Tax rate increases or selective excise taxes may reduce economic efficiency either by adversely affecting incentives to work and save, or by encouraging consumers and investors to shift resources away from their most productive uses. To the extent that they would not change the economic decisions made by polluting firms, these low-rate pollution charges would neither improve nor reduce economic efficiency. Thus, the low-rate pollution charges may be preferred to some other ways of raising revenue on efficiency grounds. In addition, some people argue that even firms that comply with existing regulations impose costs on society. Pollution charges allow the government to recover some of these costs on behalf of all citizens by charging firms for their degradation of the environment rather than allowing them limited, but free, use of the country's natural resources.

Opponents of these charges argue that the industries that would pay the taxes already bear significant costs to comply with the government's environmental regulations. These charges would increase costs for the affected firms and their customers, without providing significant benefits in the form of improved environmental quality.

To administer pollution charges, the government must have economical methods for monitoring or estimating emissions from specific sources. The costs of administration and compliance would depend on the monitoring methods already in place.

Tax SO_2 and NO_x Emissions. Stationary sources in the manufacturing and electric utility sectors could be charged \$50 per ton on SO_2 emissions and \$100 per ton on NO_x emissions. Taxing these two pollutants at these rates would raise about \$4 billion from each in 1989 through 1993.

Environmental Protection Agency (EPA) regulations require direct monitoring and reporting of SO_2 and NO_x emissions from stationary sources built since the Clean Air Act of 1970, and thus it would not be difficult to tax emissions from these sources. However, federal reporting is not required for older sources that produce the bulk of all SO_2 and NO_x emissions. One possibility would be to base the charges for older sources on state regulatory data. Most states issue permits for a maximum amount of emissions from each source. Pollution charges could be based on these amounts or on more precise estimates of emissions. The states could be required to submit the necessary data to the federal government, or to collect the pollution charges themselves, possibly in exchange for a share of the proceeds.

State-regulated electric utilities would pay most of the taxes because they are the main sources of SO_2 and NO_x emissions. State regulators would determine how much of the charges could be passed to the utilities' ratepayers and how much would be borne by the utilities' stockholders. Even if the charges were fully added to electric rates, changes in electricity output (and in SO_2 and NO_x emissions) probably would be negligible, both because the taxes would be small relative to current electric rates and because demand for electricity is fairly insensitive to price changes, at least in the short run.

Tax Hazardous Wastes. A tax of $5 per metric ton on the generation of hazardous wastes, currently regulated by the EPA under the Resource Conservation and Recovery Act, would raise revenues by about $4 billion in 1989 through 1993. In the longer term, revenues might be reduced as firms adopt production technologies that generate less hazardous waste.

Current federal law mandates procedures for handling hazardous waste and the disposal technology to be used. The imposition of a waste tax might require new reporting and monitoring procedures beyond those currently employed by EPA. A waste tax also would increase incentives to evade federal regulation completely by disposing of wastes illegally. Opponents of a federal waste tax also note that many states already impose such charges.

APPENDIX

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CONGRESSIONAL
BUDGET OFFICE
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